

# Carleton College

One North College Street  
Northfield, Minnesota 55057

September 25, 2015

Dear Mr. Weitz and members of the Investment Committee,

The faculty, staff, and students on the Carleton Responsible Investment Committee (CRIC) want to thank the members of the Investment Committee of the Board of Trustees for your thoughtful letter of March 3, 2015. We also appreciate the time of Trustee Justin Wender during our productive meeting with him in early May.

As it is stated in our charter and recognized in your letter, CRIC's mission is "to advise the Investment Committee of the Board of Trustees [...] regarding ethical, social, and environmental issues that arise in the management of the college endowment."<sup>1</sup> Climate change poses many such issues. We agree with your assessment that "there is no significant disagreement across the Carleton community over the existence of climate change, the dangers it presents, and the need for collective, worldwide action to reduce harmful CO<sub>2</sub> and other greenhouse gas emissions and help secure the health of our planet." Our research over the past months has only strengthened our belief that we all find ourselves near a dangerous tipping point.

The nations of the world have agreed that we cannot increase the heating of the planet above 2°C, which means we can only afford to emit roughly 550 more gigatons of carbon dioxide.<sup>2</sup> Since the current global reserves of fossil fuels amount to around 2800 gigatons, this means we must keep four-fifths of proven reserves unburned or we risk, in the words of the Intergovernmental Panel on Climate Change (IPCC), consequences that will likely be "severe, pervasive, and irreversible."<sup>3</sup> Continuing as usual would produce warming of 4°C or even 6°C, which would cause millions to be displaced by rising sea levels, famine due to the effects of extreme heat waves and droughts, and the destruction of key ecosystems.<sup>4</sup> This stark math and its catastrophic real-world effects has called into question the core business model of fossil fuel companies, which is to extract and sell coal, natural gas, and oil, and also their involvement in any unnecessary prolongation of a carbon-based society, including manipulation of the market and the obstruction of a transition to a low-carbon economy.

With growing calls for fossil fuel divestment from many parts of the Carleton community, CRIC decided to explore the issue. In the fall and early winter of 2014, after an initial consideration of divestment, we decided that the important connection between fossil fuels and climate change made divestment potentially warranted and we recommended in our February 2015 annual report and meeting with the Investment Committee to create a task force that would specifically examine fossil fuel divestment, as has been done in other colleges as well as at Carleton during the South African Apartheid divestment debate.

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<sup>1</sup> "CRIC Charter" (<https://apps.carleton.edu/governance/cric/charter/>)

<sup>2</sup> This estimate is the amount of CO<sub>2</sub> that can be emitted prior to 2050 to maintain an 80% chance of avoiding 2°C of warming.

<sup>3</sup> IPCC, "Climate Change 2014: Synthesis Report," 2014, p.1. ([https://www.ipcc.ch/news\\_and\\_events/docs/ar5/ar5\\_syr\\_headlines\\_en.pdf](https://www.ipcc.ch/news_and_events/docs/ar5/ar5_syr_headlines_en.pdf))

<sup>4</sup> Potsdam Institute for Climate Impact Research and Climate Analytics, *Turn Down the Heat--Why a 4C Warmer World Must Be Avoided*, 2012. (<https://openknowledge.worldbank.org/handle/10986/11860>)

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After the Investment Committee's March response to our recommendations, CRIC itself took on the responsibility as the fossil fuel divestment task force. We agreed early on to focus our discussions on divestment from our direct holdings and not from our commingled funds, as the latter seemed far too complicated and unrealistic at the present moment given the College's investment strategies. Over the following three months, CRIC tasked itself with looking more deeply at the moral arguments for divestment, the costs and benefits of divestment, and other alternative responsible investment strategies that could focus on the same issues that divestment sought to address. Regarding the last point, although we were originally tasked with exploring the strategy of fossil fuel divestment, we thought it necessary to also explore other responsible investment strategies with respect to climate change. We therefore also looked at Environmental Social and Governance (ESG) investing as well as shareholder engagement.

The reason behind looking at more than just divestment is that we came to the understanding that the ultimate goal we, CRIC, would like to endorse with our responsible investment strategy is keeping to the carbon budget and 2°C limit established by the IPCC.<sup>5</sup> While divestment was central to our discussions as the task force, our primary and foundational question was not necessarily whether Carleton should divest from fossil fuel companies or not, but rather what would be the best responsible investment strategy for Carleton to implement with an eye toward this ultimate goal. The former question should in this sense fall under the latter question, and all responsible investment strategies with respect to climate change or global warming should use this ultimate goal as its main measure of success.

To conclude that divestment from fossil fuel companies is warranted (and whether it should be part of our optimal responsible investment strategy), we would seemingly have to meet two conditions or come to two conclusions. The first conclusion is that the connection between climate change and fossil fuel companies makes holding these stocks ethically problematic. The second conclusion is that other responsible investment strategies are not sufficiently effective and that divestment adds additional value that is not captured by these other strategies. Divestment should only be turned to after it is determined that it adds net benefit/value to our strategy that is over and above that which is obtained with other options. In this sense, the strategy of divestment is the last option that should be turned to when evaluating our overall responsible investment strategy.

After several months of intensive research, regular weekly meetings and discussions, and interaction with students, alumni, faculty, and staff, *the members of CRIC have come to believe that the connection between fossil fuel companies and climate change does in fact make holding stock in these companies ethically problematic.* Furthermore, we concluded that our optimal responsible investment strategy should include both a robust climate change-related ESG integration into Carleton's investment strategy as well as fossil fuel divestment. We believe divestment is warranted even with ESG integration. And while we think that either ESG or divestment alone is a good strategy, and that the Investment Committee could accept one without the other, we also believe that both together make up the best responsible invest-

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<sup>5</sup> This goal of keeping to the IPCC target is consistent with Carleton's own established climate goals as mentioned in the American College and University Presidents' Climate Commitment (ACUPCC), signed by Carleton President Robert Oden, Jr. in 2007: "We further recognize the need to reduce the global emission of greenhouse gases by 80% by mid-century at the latest, in order to avert the worst impacts of global warming." The 80% emissions reductions are broadly consistent with the 2°C target.

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ment strategy to help reach our climate goals. Specifically, we recommend the Investment Committee to:

- (1) Thoroughly explore the possibilities of ESG integration into Carleton’s investment strategy and make a formal ESG investment policy, with particular emphasis on climate change-related ESG issues.
- (2) Engage directly with our external investment managers and ask them to focus more on climate change-related risks and performance indicators when making investment decisions.
- (3) Divest from fossil fuel direct holdings in our endowment.<sup>6</sup> Of the eight voting members of CRIC, seven felt that we should divest from the top 200 fossil fuel companies as determined by Fossil Free Indexes.<sup>7</sup> One member felt that we should only divest from the top 100 coal companies, and her opinion is attached to this report.

We recognize that fossil fuel companies are not selling in a vacuum, but that demand for fossil fuel remains high. We must all reduce our usage of fossil fuels in favor of renewable energy sources such as solar and wind, and we encourage individuals in the Carleton community and beyond to do so. We enthusiastically endorse Carleton’s pledge to go carbon neutral by 2050. Much more must be done by the world community to reduce our dependence on fossil fuels and effect the transition to other energy sources. But we also feel that an examination of the suppliers of fossil fuels is an important part of the climate change dilemma, and that action with respect to these suppliers is a potentially important tool in the toolkit necessary to combat climate change.

Furthermore, we believe that our recommendations are in harmony with Carleton’s stated values, and are consonant with official positions of the College such as:

We believe colleges and universities must exercise leadership in their communities and throughout society by modeling ways to minimize global warming emissions, and by providing the knowledge and the educated graduates to achieve climate neutrality. Campuses that address the climate challenge by reducing global warming emissions and by integrating sustainability into their curriculum will better serve their students and meet their social mandate to help create a thriving, ethical and civil society... We further recognize the need to reduce the global emission of greenhouse gases by 80% by mid-century at the latest, in order to avert the worst impacts of global warming.” —*American College and University Presidents’ Climate Commitment (ACUPCC), signed by Carleton President Robert Oden, Jr. in 2007.*<sup>8</sup>

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<sup>6</sup> As of June 2015, only \$4,312,998 out of our total direct holdings of \$135,602,516 (3.2%) was invested in fossil fuel companies, or roughly 0.54% of our approximately \$800 million total endowment.

<sup>7</sup> “The Carbon Underground 2015.” ([www.fossilfreeindexes.com/research/the-carbon-underground](http://www.fossilfreeindexes.com/research/the-carbon-underground)) The top 200 list is based on the potential carbon emissions content of a company’s reported fossil fuel reserves. (see Divestment Section §2.7.)

<sup>8</sup> “Text of the American College & University Presidents’ Climate Commitment.” (<http://www.presidentsclimatecommitment.org/about/commitment>)

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Carleton College recognizes that it exists as part of interconnected communities that are affected by personal and institutional choices. We are dedicated, therefore, to investigating and promoting awareness of the current and future impact of our actions in order to foster responsibility for these human and natural communities. Carleton strives to be a model of environmental stewardship by incorporating ideals of sustainability into the operations of the College and the daily life of individuals.<sup>9</sup>

—*Carleton College Board of Trustees, 2001.*

These statements point to Carleton’s concern about the future of the planet in light of global climate change. The important concept of intergenerational equity which also emerges—that we should be thinking about future generations, and especially future generations of Carleton students—underpins CRIC’s position that we must undertake significant action to reduce the warming of the Earth, of which divestment is a part. The issue of intergenerational justice should be particularly important to Carleton, whose mission extends to the education of future generations. We have a particular interest in the kind of world in which future graduates will live.

CRIC appreciates the willingness of the Board of Trustees to consider our thoughts and recommendations on these important issues.

#### COMMITTEE MEMBERS

Anil Methipara (Co-Chair, '16)	David Tompkins (Co-Chair, Fac.)	Jason Decker (Faculty)
Emily McAdam (Staff)	Melissa Thomas (Staff)	Vicky Wu ('17)
Perrin Stein ('17)	David Coleman ('17)	

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<sup>9</sup> “Environmental Statement of Principles as Approved by the Board of Trustees and the EAC.” ([https://apps.carleton.edu/governance/environment/history/eac\\_approved/](https://apps.carleton.edu/governance/environment/history/eac_approved/))

# REPORT AND RECOMMENDATION ON FOSSIL FUEL DIVESTMENT AND ESG INVESTING

CARLETON RESPONSIBLE INVESTMENT COMMITTEE (CRIC)

September 25, 2015

## Contents

<b>1 ESG Investing</b>	<b>2</b>
1.1 Background	2
1.2 The Benefits of ESG Investing	2
1.3 Limitations of ESG Investing	3
1.4 Specific ESG Recommendations	7
<b>2 Divestment</b>	<b>9</b>
2.1 Ethical Issues	9
2.2 Effectiveness and Impact of Our Recommendation	12
2.3 Financial Aspects and Risks/Benefits of Divestment	13
2.3.1 Evidence that Divestment Would Not Affect, or Would Help, Endowment	13
2.3.2 Evidence that Divestment Would Negatively Affect Endowment	14
2.3.3 Other Considerations	14
2.3.4 Conclusions	15
2.4 On the Political Nature of Divestment	15
2.5 History	16
2.6 Other Schools and Divestment	17
2.7 From Which Companies to Divest?	17
2.7.1 Divestment from the Top 200	17
2.7.2 Minority Opinion	18
<b>3 Conclusion</b>	<b>19</b>
<b>4 Appendix</b>	<b>21</b>

# 1 ESG Investing

## 1.1 Background of ESG Investing

Environmental, social and governance (ESG) investing can be defined as an investment strategy that “involves integrating the three ESG factors into fundamental investment analysis to the extent that they are material to investment performance.”<sup>1</sup> ESG investing has usually fallen under the umbrella of responsible investing. However, ESG differs from other responsible investing strategies by directly incorporating environmental, social, and governance factors into the risk and return analysis of an asset. The incorporation of these non-traditional ESG factors into investment evaluation helps to bring about a new paradigm of risk assessment, and thus investment evaluation and prioritization. It is not *necessarily* based on avoiding or embracing something for a political or ethical reason, but rather on trying to more fully assess the long term consequences of these additional factors that may be poorly understood by—or not fully incorporated into—more traditional investment market valuations. ESG investing therefore provides added information and insight about likely long term performance and regulatory risk.

ESG factors are incorporated into the investment analysis by evaluating a company’s exposure to risk with respect to the environmental, social, and governance categories. The specifics of how this is evaluated depend on the specific ESG rating agency and its model/metrics/rating system. Most models give companies a rating/score on each category E, S, and G. These scores are based on multiple key performance indicators in each category (e.g., CO<sub>2</sub> emissions and Spills and Pollution Controversies for E, employee turnover and philanthropic donation total for S, and audit committee independence and experienced board for G).<sup>2</sup> Rating agencies collect data on the multiple performance indicators for each ESG category and use a mathematical model to calculate a score for each of the three categories for each company. They also often have sub-scores within each category as well as a holistic ESG score for the company. Again, the specific methodology and score depends on the rating agency and its model, particularly the data collected and the weights given to each performance indicator. The scores/ratings outputted by the models function in some sense like bond ratings in that they are supposed to communicate the level of risk a company faces within a given ESG category.<sup>3</sup>

## 1.2 The Benefits of ESG Investing

With respect to climate change and keeping to our goal of a 2°C warming limit, ESG as an investing strategy has many potential benefits. ESG investing has the ability to act on the climate problem by reducing demand for and consumption of fossil fuels. Companies with high CO<sub>2</sub> and other greenhouse gas emissions could be penalized, relative to low-emission companies, with lower Environmental scores, and therefore with lower overall scores. As more investors seek returns that are subject to less environmental risk, they will more often avoid high emitters and channel their investments to low emitters. Companies with less environmental risk, then, would attract more capital. In addition, as more banks and investment firms

<sup>1</sup> Commonfund Institute, *Commonfund Study of Responsible Investing: A Survey of Endowments and Their Affiliated Foundations*, 2015, p. 2. ([https://www.commonfund.org/InvestorResources/Publications/White%20Papers/ResponsibleInvestingStudy\\_FINAL3.pdf](https://www.commonfund.org/InvestorResources/Publications/White%20Papers/ResponsibleInvestingStudy_FINAL3.pdf))

<sup>2</sup> Thomson Reuters, “Thomson Reuters ESG Data: In-Depth Environmental, Social and Governance (ESG) information on 5,000 Global Companies,” 2015, p.2. (<http://financial.thomsonreuters.com/content/dam/openweb/documents/pdf/financial/asset4-esg-data-fact-sheet.pdf>)

<sup>3</sup> For example, MSCI ESG Research rates companies within an AAA (best) and CCC (worst) rating spectrum. (MSCI ESG Research, “ESG Ratings Methodology: Executive Summary,” 2015, p.5. (<https://www.msci.com/documents/10199/123a2b2b-1395-4aa2-a121-ea14de6d708a>))

offer ESG strategies as investment vehicles, even more money would be available to companies that meet investors' environmental risk criteria. Early studies of ESG investing have shown that the cost of capital is lower for highly rated ESG companies.<sup>4</sup> In the long run, this might translate into improved performance. This gives material incentives for high emitters to reduce emissions and meet the environmental standards set by ESG investors.

Furthermore, as more investors seek to establish ESG certification for their portfolio, it is likely that a greater coherence will emerge in the markets for credible and standardized ESG criteria, accounting, and benchmarks, which currently do not exist. To the extent that accounting and benchmarks become more widely accepted, further pressure will grow on companies to adopt these practices, or on the SEC or others to enforce them. Thus ESG investing, especially when implemented for a sustained period of time and with a critical mass of investors, can exhibit long term market influence and facilitate the reorientation of the markets to consume less fossil fuel.

Another benefit that an ESG strategy has, compared to divestment in particular, is its broad reach. ESG factors and risks, particularly those related to climate change, affect all sectors of the economy. Carbon emissions are a problem that almost all businesses and consumers have to face. ESG investing can therefore affect demand and consumption of fossil fuels in all sectors of the economy, and does not just target the top 200 fossil fuel companies. This extensive reach and influence is required for a real climate solution. Our climate context demands severe reductions in fossil fuel consumption and carbon emissions every year, as the ACUPCC statement makes clear. Individual consumers or businesses will not make much of a dent in carbon reductions if they reduce their demand, but if an entire economy is oriented to change its behavior and reduce its demand, then we have a more realistic chance of keeping to the 2°C limit. ESG facilitates this economy-wide reorientation.

ESG also facilitates the efficient financing of the transition to a low carbon society. Some of the central issues of the climate change problem include how to finance climate change adaptation and mitigation, and who will finance it. ESG facilitates a role for the markets and private players to finance this transition, not just governments or public-private partnership schemes. An effective rating system would facilitate capital going to the most efficient companies and technologies. It would also help direct capital and demand to alternative energy technologies given that companies using these technologies will have lower emissions and therefore face reduced environmental risk.

Finally, ESG investing has the benefit of being in line with fiduciary duty. This is true on both the theoretical and empirical level. Theoretically, the incorporation of ESG factors helps investors better understand the risks associated with a company, and therefore ESG risks are priced into the decision making process of investment managers. ESG risks are connected to material performance, and the pricing or integrating of this risk into traditional risk assessment is what makes ESG investing compatible with fiduciary duty. Empirically, we find studies that “show that companies with high ratings for ESG factors exhibited market-based outperformance” in the medium to long term.<sup>5</sup> Thus, there is potential for superior risk-adjusted returns with ESG integration, especially when looking at the long-term.<sup>6</sup>

### 1.3 Limitations of ESG Investing

ESG, like any strategy, also has its limitations, and it is important to identify them in order to use ESG effectively for our investment goals. One limitation is that there are no standardized approaches or metrics

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<sup>4</sup> Deutsche Bank Group, *Sustainable Investing: Establishing Long-Term Value and Performance*, 2012, p.5. ([https://institutional.deutscheawm.com/content/\\_media/Sustainable\\_Investing\\_2012.pdf](https://institutional.deutscheawm.com/content/_media/Sustainable_Investing_2012.pdf))

<sup>5</sup> Ibid., p.5.

<sup>6</sup> Ibid., p.9.

when applying ESG. Given that ESG investing as a tool has only recently begun to be incorporated into mainstream investing, universally accepted standards for disclosing, collecting, analyzing, and interpreting ESG data have not emerged. Therefore, there is no obvious consensus on the best way to develop or integrate ESG into investing strategies; in other words, ESG “best practice’ is a work in progress.”<sup>7</sup> Because of this, models and methodologies are often tailored to an individual investor or rating agency’s judgment or preferences.

This is not necessarily a bad thing, but it does mean that finding or developing an ESG integration approach based on our goals, values, and understanding of risk would require taking time to consult with experts and deliberate on the best approaches. However, we see this lack of consensus as a compelling reason to actively engage in these deliberations. We believe, as we stated earlier, that greater coherence and uniformity will likely emerge in the investment world as more and more investors demand ESG certification. We see this greater coherence and usability of ESG metrics as a general good especially given the potential financial and social benefits associated with ESG investing. Carleton’s engagement in this process can therefore contribute to the on-going movement of improving ESG integration and establishing best practices.<sup>8</sup>

Other potential limitations are related to the effectiveness of ESG in addressing specifically climate change-related issues. These limitations stem from the methodology and model construction for ESG ratings themselves. Again, there is no standardized methodology or model for ESG ratings, and different rating agencies have different rating systems. But there is also the fundamental question of how to construct a model. ESG models weight multiple performance indicators in order to generate what is deemed the most appropriate ESG rating. Weightings, however, are to a certain degree based on value judgments and the agency’s or investor’s understanding of risk. Indeed, one ESG model constructor we came across, Thomson Reuters, acknowledged that “[t]here can be no definitive and universally accepted right or wrong way to weight and model the Key Performance Indicators.”<sup>9</sup>

Giving the appropriate weights to particular performance indicators and issues (e.g., CO<sub>2</sub> emissions, energy efficiency, and clean energy product innovation) is necessary to make ESG an effective tool in combating climate change. It is unclear, however, the degree to which ESG will be effective in addressing climate change given the methodologies and scoring systems that agencies and investors use. If investors are primarily looking at a company’s holistic ESG score, climate change-related issues will be “diluted” by other issues in the score. In this case, a company that performs poorly on climate change-related issues can still have a good ESG score if they perform well on other issues, such as those associated with the Social and Governance categories.

Also, if investors perceive that Environmental risk identified by the E score is not very important to material performance relative to other risks, then they will largely overlook this score compared to other scores. In terms of material performance, the G category, associated mainly with corporate governance, is seen to be the most important factor related to material performance, and therefore the ESG factor that

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<sup>7</sup> Northern Trust, *The Challenges of ESG Investing—Regulation*, 2015, p. 1. (<https://www.northerntrust.com/documents/white-papers/asset-management/challenges-of-esg-regulation.pdf>)

<sup>8</sup> A recent example of an institutional investor helping to produce knowledge on ESG best practices and to “spark investment management innovation” is the California Public Employees’ Retirement System (CalPERS), which both tried to identify ESG practices as well as “[set] up an investment demand for better sustainability data and better modelling, and fundamentally, the integration of these factors into financial reporting.” (“CalPERS to transform ESG to ‘data-driven mainstay’ of investment.”(<http://www.ipe.com/news/esg/calpers-to-transform-esg-to-data-driven-mainstay-of-investment/10008808.fullarticle>))

<sup>9</sup> Thomson Reuters, *Thomson Reuters Corporate Responsibility Ratings (TRCRR): Rating and Ranking Rules and Methodologies*, 2013, p. 4. (<http://thomsonreuters.com/content/dam/openweb/documents/pdf/tr-com-financial/methodology/corporate-responsibility-ratings.pdf>)



counts most for investors.<sup>10</sup> This is not necessarily a bad thing; it makes sense that the G category is ranked highest. Furthermore, a company with good corporate governance would likely be better able to manage environmental risks than a company with poor corporate governance (if that is what was being demanded by the markets). But the weight given to the G category by investors and ESG models makes it less clear how much weight climate change-related ESG factors themselves can/should be given and to what degree ESG scores or investors will respond to poor climate change-related performance.

Even having a good Environmental category score may not always mean having good climate change-related performance as climate change is often one of several Environmental sub-categories. For example, climate change is one of four sub-categories in MSCI ESG Research's Environmental category (the other three sub-categories being Natural Resources, Pollution & Waste, and Environmental Opportunities).<sup>11</sup> Performing well on the S and G categories as well as the other sub-categories within the E category is obviously not a bad thing; indeed, it should be applauded. But it still shows that the scores may be less useful when trying to specifically address climate change.

Thus, it becomes unclear to what extent ESG investing can affect climate change, through incentivizing behavior like reducing greenhouse gas emissions or deforestation, if climate change indicators are "diluted" in the Environmental category, and even more so in the holistic ESG score. This, however, does not mean that ESG is not worth pursuing; there is still great potential for ESG to address climate change issues effectively. When deliberating on how to integrate ESG investing, we should be aware of these issues and make sure to adequately incorporate environmental/climate risks.

Ideally, we would like to see ESG models that focus more on—or give more weight to—climate change-related indicators. We see this as the best way to facilitate the necessary changes in the markets in order to maintain our goal of a 2°C warming limit. While CRIC has and still advocates for greater responsible investing and corporate accountability for all ESG-related issues, CRIC believes that the immensity and urgency of climate change in the present moment makes climate change-related issues a particular priority and would justify our wish for a "climate change-heavy" ESG model in which climate change issues are weighted in such a way that real, significant climate change-related incentives would emerge for companies.

Some ESG tools do offer features that allow client specification of ESG analysis and access to scores and weights outside of the holistic score and the E, S, and G category scores. This would include the scores and weights for the ESG issues that a client is most interested in, such as carbon emissions or energy efficiency if focusing on climate change, or labor management, health and safety, or anti-competitive practices if focusing on other issues.<sup>12</sup> CRIC does not know much about the specifics of client customization of ESG, but this is something that we think should be explored and deliberated on when thinking about pursuing an ESG investing policy for Carleton.

The final limitation CRIC identified with ESG investing is in relation to the strategy of divestment. That is, ESG investing, in some sense, is a passive and indirect approach in *affecting* climate change risks and regulation. To understand exactly what this means, we need to understand what "ESG risk" means. If we were looking at environmental risk or climate change risk, for example, we would not be talking about the risks the environment or the climate face as a result of a company's business practices. Rather, we would be talking about how these environmental outcomes associated with those business practices might adversely affect a company's material performance, its bottom line. But how would these outcomes

<sup>10</sup> Deutsche Bank Group, *Sustainable Investing: Establishing Long-Term Value and Performance*, 2012, p.5. ([https://institutional.deutscheawm.com/content/\\_media/Sustainable\\_Investing\\_2012.pdf](https://institutional.deutscheawm.com/content/_media/Sustainable_Investing_2012.pdf))

<sup>11</sup> MSCI ESG Research, "ESG Ratings Methodology: Executive Summary," 2015, p.4. (<https://www.msci.com/documents/10199/123a2b2b-1395-4aa2-a121-ea14de6d708a>)

<sup>12</sup> *Ibid.*, p.5.

affect a company's risk and material returns? The main answer is through regulation, and the risk of future regulation.

One way ESG risk generally has been framed is the risks posed by the externalities produced by a company's business practices in virtue of the likelihood that these externalized costs will be internalized through future regulation. Internalizing costs that were previously externalized will obviously affect material performance. And while ESG is also focused on issues like the social reputation of companies, which is not a risk associated with government-imposed regulation, much of ESG risk does pertain to government regulation, especially in the Environmental category. And even some social reputation risk can be seen as a sort of "social regulation" of companies. So ESG risk is highly oriented toward looking at regulatory risk. A report on ESG by Northern Trust even mentions that "[i]nvestors should begin to think of ESG investing as a potential hedge to possible regulatory changes."<sup>13</sup>

ESG makes investors aware of these risks by identifying and measuring these regulatory risks. In the case of climate change, this might mean the recognition of higher risks associated with companies with high CO<sub>2</sub> emissions as future regulation or taxes on emissions will internalize the social cost of carbon back to the companies. But outside of identifying and measuring the risk, ESG investing does not seem to affect or change the actual risk of these companies, or in other words, it does not seem to increase the likelihood of the regulation of occurring or shorten the time horizon associated with the risk.

To give a crude example, let's say that the risk or probability that significant CO<sub>2</sub> regulations or taxes will be implemented within 2 years is 20 percent, and based on this, CO<sub>2</sub> emissions will be given a certain weight in ESG models and investors will make decisions accordingly. But will incorporating ESG investing actually affect the likelihood of regulations being implemented (the 20 percent), and therefore affect the riskiness of high emitting companies? Or does it simply identify the risk and create a weight for the risk based on the 20 percent probability? ESG seems to make investors conscious and prepared for the potential risks, but it does not seem to affect the underlying factors that can change the likelihood of regulations being implemented. To address climate change effectively and in a timely manner, it seems that the likelihood of regulation needs to also increase significantly, which ESG does not help do.

ESG investing uses a purely market-based logic and helps to re-orient the market from within. This is a necessary component to the solution, but not satisfactory by itself. ESG without the sufficient threat of regulation may be sub-optimal in terms of addressing climate change and staying under our 2°C limit. CRIC believes that addressing climate change requires policy solutions at the governmental and inter-governmental levels. Markets by themselves have a hard time dealing with externalities. Thus, CRIC believes that new regulations and/or taxes that help correctly price carbon—for example a carbon tax and the phasing out of fossil fuel subsidies—are required to tackle climate change. Ultimately, there needs to be a market-oriented solution if we hope to stay under the 2°C limit. We view these regulations and taxes as part of the market-oriented solution, as government and civil society helping to orient and accelerate the market in a particular direction.

To address climate change efficiently and to use ESG most effectively in this regard requires both regulation and ESG investing working together, as the threat of regulation enhances the effects of ESG to move markets in the required direction. Therefore, a deficiency on either the ESG front or the regulation front would lead to a sub-optimal climate change outcome. ESG investing along with the threat of impending regulation on greenhouse gas emissions would make the connection between environmental/climate risk and material performance more prominent than before because the time horizon associated with climate risk shrinks. Climate risk, therefore, would become a more urgent risk to be managed in the eyes of in-

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<sup>13</sup> Northern Trust, *The Challenges of ESG Investing—Regulation*, 2015, p. 5. (<https://www.northerntrust.com/documents/white-papers/asset-management/challenges-of-esg-regulation.pdf>)

vestors. This would in turn give more weight to climate change-related issues in ESG models and scores, which is again what we want and need.

If an optimal solution requires regulation, then what is necessary for significant policy and regulation changes to occur? One of the prerequisites for regulation, especially for climate change-related regulation, seems to be the social and political capital and will power to pass and implement such regulations. This would in turn require a shift in the social and political consciousness with respect to the threat of global warming, the 2°C limit, and the need to prioritize climate change on policy agendas. While ESG does facilitate the shifts in investor consciousness necessary for a climate solution, it does not facilitate the shifts in social consciousness and in the larger social and political scenario needed for policy change, which is also needed for a climate solution. CRIC does believe, however, that divestment would be an effective tool in bringing about such a shift (see §2.2 of this report).

In acknowledging this, we do not see ESG as “disappointing” or less attractive in any way. We do not see the purpose of ESG as affecting social or political conditions; whether or not ESG investing will affect these conditions should not be relevant when deciding to integrate ESG into our investment strategy. We are simply acknowledging that an optimal climate solution does seem to require social and political changes.

#### 1.4 Specific ESG recommendations

When looking at the potential benefits of ESG investing, specifically those related to addressing climate change, CRIC thinks it is very much worthwhile to integrate ESG investing into Carleton’s overall investment strategy. In fact, CRIC believes that ESG investing is a crucial component in the financing and transitioning to a low carbon future and in our attempts to stay under the 2°C limit. With Carleton, as well as other college and university endowments, integrating ESG investing and focusing on the collective task of improving ESG metrics and criteria (and thus ESG reporting and comparison), we believe that we would be making progress to our goal of reduced carbon consumption. From such leadership and collective action could come very powerful transformation and ultimate redirection of capital and consumption patterns. Although we have identified a few potential limitations of ESG investing, this merely illustrates that ESG integration requires diligent work to implement well, but it is still a vital part of the solution.

To this end, CRIC would like to make two recommendations to the Investment Committee:

- (1) **Thoroughly explore the possibilities of ESG integration into Carleton’s investment strategy and make a formal ESG investment policy, with particular emphasis on climate change-related ESG issues.** Part of this exploration might include discussions on the following:
  - The intention behind adopting any ESG policy
  - The main ESG issues and indicators we want to integrate
  - The type of ESG metrics, models, and weights we would like to use
  - How such metrics and models can be developed
  - How to specifically use and interpret ESG ratings in investment analysis
  - Whether Carleton can or should have a customized ESG approach
  - How ESG integration should affect the selection of external investment managers
  - The level of ESG integration into our investment strategy
  - How ESG integration will affect financial returns

In the current state of our exploration, many of these questions remain open. While CRIC has some initial inclinations as to what the Investment Committee should decide (e.g. trying to make climate change as important as it can be in ESG models), we also face a lot of unknowns at this point of time, like the specifics of ESG models, how investment managers should specifically interpret ESG risk, and the effect ESG integration will have on financial performance, to name a few. Through the process of exploration and discussion within the Investment Committee as well as continued collaboration and dialogue with the Investment Office, CRIC, our investment managers, and relevant experts in the field, we hope that the Investment Committee can develop the answers to these questions, and from these answers adopt a formal policy on how Carleton should integrate ESG investing.

- (2) **Engage directly with our external investment managers and ask them to focus more on climate change-related risks and performance indicators when making investment decisions.**

While we deliberate on what Carleton's ESG integration policy should be—a process that might take a considerable amount of time—in the meantime we can also start engaging with our investment managers on these issues. We can do so by writing a letter to our investment managers stating Carleton's position on the threat of climate change and the need to mitigate both climate change and climate change-related investment risks. A good example and potential model for such a letter is the letter written by Yale University's Chief Investment Officer, David Swensen, to Yale's external investment managers (full letter in Appendix). An excerpt of the letter is as follows:

Climate change (caused by deforestation and emissions of carbon dioxide, methane and other gases) creates a substantial risk of significant changes to the world's ecosystem and in actions to address those changes, making consideration of the impact of climate change essential when evaluating investment opportunities. Yale asks that when making investment decisions on the University's behalf, you assess the greenhouse gas footprint of prospective investments, the direct costs of the consequences of climate change on expected returns, and the costs of policies aimed at reducing greenhouse gas emissions on expected returns. Simply put, those investments with relatively small greenhouse gas footprints will be advantaged relative to those investments with relatively large greenhouse gas footprints.<sup>14</sup>

The sentiments in his letter match Carleton's values and approach to the issue of climate change. It is also one strategy of ESG integration. By sending such a letter to our investment managers we would be asking them to appropriately weigh climate change-related risks, which is one of the goals Carleton should have when formulating its formal ESG policy. This engagement is an extension of Carleton's previous climate-related actions in that it is another proactive and intentional way that Carleton is trying to help the world keep to the goal of a 2°C warming limit.

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<sup>14</sup> "David Swensen on the Fossil Fuel Divestment Debate." (<http://www.cfapubs.org/doi/full/10.2469/faj.v71.n3.3>)

## 2 Divestment

### 2.1 Ethical Issues

We have already outlined the threat that climate change poses to the world. Given the enormity and complexity of the problems associated with transitioning to a low carbon economy, all stakeholders, including and especially fossil fuel companies, have a role to play in bringing about a timely and efficient solution. If any stakeholder is not doing *all* they can reasonably do to help stick to our global climate goals and to make the transition as quickly and efficiently as possible, then they are effectively delaying action, which we find morally problematic. Any such delays motivated by short term self-interest need to be highlighted as endangering life on the planet.

We acknowledge that we do not want fossil fuel companies to simply disappear in the next few years. That would indeed be foolish thinking. The transition to a low carbon economy is a long term process, and we will definitely need to rely on fossil fuels in the short to medium term. But the problem arises when actions for the transition are mired in delays and unnecessary confusion, when the time period allotted for fossil fuel use gets unnecessarily extended, and therefore when the status quo of carbon-based energy is unnecessarily prolonged. Additional prolongation (i.e., prolongation that is over and above the prolongation that is already necessary in the most efficient transition scenario) is both very risky and morally problematic given the current climate scenario. It is obvious that the quicker the transition away from fossil fuels, the better the chances are for mitigating global warming. Additional prolongation of the status quo for 2 years, 1 year, or even 1 month puts us in more danger than is required and is not consistent with Carleton's climate goals and values.

CRIC, therefore, believes that an unnecessary prolongation of the fossil fuel economy is morally problematic. CRIC believes that fossil fuel companies, and specifically companies on the top 200 list, are guilty of this. Through their own actions as well as connections with trade association groups, they have helped create an environment that unnecessarily prolongs their core business model of extracting and selling fossil fuels. This has been largely achieved through enabling platforms for misinformation, funding climate change deniers, and obstructing climate action.

This misinformation is presented to the public and to policy makers. While their product (fossil fuels) has obvious societal benefits, the true societal costs have been clouded by “carefully planned campaigns of deception organized by companies and by trade groups representing the industry [who aimed] to deliberately sow confusion and block policies designed to reduce the heat-trapping emissions that cause global warming.”<sup>15</sup> This is similar to the case of the tobacco industry misleading the public about the true harms associated with its product.<sup>16</sup> An important difference here is that the costs associated with smoking are largely personal, while the costs associated with fossil fuels are far more wide reaching.

Companies that extract and sell fossil fuels will naturally be resistant or hesitant to accept any policies that threaten the viability of their traditional business model. With powerful fossil fuel-related interest groups baked into our democratic process, our government also adopts an institutional inertia, leading to delays in needed climate change policies and laws. This can be evidenced by the fact that the fossil fuel industry disproportionately funds politicians who deny climate change<sup>17</sup> and that recently, at the indus-

<sup>15</sup> Union of Concerned Scientists, *The Climate Deception Dossiers: Internal Fossil Fuel Industry Memos Reveal Decades of Corporate Disinformation*, 2015, p. 2. (<http://www.ucsusa.org/sites/default/files/attach/2015/07/The-Climate-Deception-Dossiers.pdf>)

<sup>16</sup> “United States v. Philip Morris (D.O.J. Lawsuit).” (<http://publichealthlawcenter.org/topics/tobacco-control/tobacco-control-litigation/united-states-v-philip-morris-doj-lawsuit>)

<sup>17</sup> With respect to the 114th Congress: “The 38 climate deniers in the Senate have taken \$27,845,946 in donations from the coal, oil and gas industries, while the 62 Senators who haven’t denied the science have taken \$11,339,967 in career contributions, according to the CAP Action analysis. On average, Senate deniers took \$732,788 from fossil fuel interests while other Senators

try's urging, Congress has blocked critically needed climate and energy policies and launched dozens of legislative attacks on existing environmental protections that protect our clean air and water.<sup>18</sup> We cannot afford this appeasement of fossil fuel special interests and commitment to status quo energy policies.

While we talk broadly about the fossil fuel industry here, we can also connect these unethical behaviors to particular companies on the top 200 list. This connection can be made most clearly through membership in trade associations that engage in unethical behaviors. This connection to trade associations is valid given that companies influence climate policy more through business and trade associations than other routes.<sup>19</sup> It is often the industry trade associations that look out for the general interests of the industry and directly block and delay climate action.<sup>20</sup>

The most relevant trade association in this context is the American Petroleum Institute (API). The API includes 25 members that are on the top 200 list, 21 of which are oil and gas companies. Since the top 200 list is divided into the top 100 coal companies and the top 100 oil and gas companies, the API then represents 21 percent of oil and gas companies on the list. This is quite a significant representation given that API members are only American companies or subsidiaries, and that American fossil fuel companies' reserves account for only 11 percent of the total potential carbon emissions in the top 200 companies' reserves.<sup>21</sup> Furthermore, 6 of the 10 fossil fuels companies in Carleton's direct holdings that are on the top 200 list, and 6 of the 7 American fossil fuel companies in the direct holdings, belong to the API (Alcoa, Anadarko Petroleum, Devon Energy, Freeport-McMoran, Noble Energy, and Occidental Petroleum). While the API may not be the cleanest proxy for the entire top 200 list or the entire fossil fuel industry, it does in a sense represent the "US Oil and Gas Industry."

If we find the API unethical in any way, then we would be able to say that this industry and companies are being unethical as well since the members pay for the API's activities. And indeed, the API has been a part of misinformation campaigns, funding of climate deniers, and fighting against climate action. Some of its actions include helping to defeat of a fossil fuel tax in 1993<sup>22</sup> and organizing its own "Global Climate Science Communications Plan" in 1998 which attempted to manufacture uncertainty among the public about climate science in an effort to derail support for potential regulations like the Kyoto Protocol.<sup>23</sup> More re-

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took \$182,902. On the House side, the 131 climate science deniers have taken \$35,702,245 in fossil fuel industry contributions while the remaining voting members who haven't denied the science have only taken \$24,268,787 in career contributions. On average, House deniers took \$272,536 from coal, oil and gas interests while other members took \$80,095." ("The Anti-Science Climate Denier Caucus: 114th Congress Edition." (<http://thinkprogress.org/climate/2015/01/08/3608427/climate-denier-caucus-114th-congress/>))

<sup>18</sup> Oil Change International and Sierra Club, "Polluting Our Democracy and Our Environment: Dirty Fuels Money in Politics," 2014. (<http://priceofoil.org/2014/04/23/polluting-democracy-environment-dirty-fuels-money-politics/>)

<sup>19</sup> In a survey, "[o]f the 403 companies in the Global 500 that responded to CDP [Carbon Disclosure Project], 71 percent stated that they engaged with policymakers on climate change legislation through their trade associations, and 61 percent directly engaged with policymakers." (United Nations Global Compact, *Guide for Responsible Corporate Engagement in Climate Policy: A Caring for Climate* Report, 2013, p.26. ([https://www.unglobalcompact.org/docs/issues\\_doc/Environment/climate/Guide\\_Responsible\\_Corporate\\_Engagement\\_Climate\\_Policy.pdf](https://www.unglobalcompact.org/docs/issues_doc/Environment/climate/Guide_Responsible_Corporate_Engagement_Climate_Policy.pdf)))

<sup>20</sup> Union of Concerned Scientists, *Tricks of the Trade: How companies anonymously influence climate policy through their business and trade associations*, 2014, p. 2. (<http://www.ucsusa.org/sites/default/files/legacy/assets/documents/center-for-science-and-democracy/tricks-of-the-trade.pdf>)

<sup>21</sup> This is compared to Russian and Indian companies (17 percent each) and Chinese companies (25 percent).(Fossil Free Indexes, "The Carbon Underground 2015 Edition," 2015, p.7. ([https://divestmaine.files.wordpress.com/2015/02/ffi-thecarbonunderground200-2015\\_11-feb-2015sud2.pdf](https://divestmaine.files.wordpress.com/2015/02/ffi-thecarbonunderground200-2015_11-feb-2015sud2.pdf)))

<sup>22</sup> Fossil Free MIT, "The Fossil Fuel Industry's Role in Hindering Climate Change Action: Lobbying and Disinformation Against Science and Scientists," 2014, p.4. (<http://www.fossilfreemit.org/wp-content/uploads/2014/08/FossilFreeMIT-Lobbying-Disinformation.pdf>)

<sup>23</sup> Union of Concerned Scientists, *The Climate Deception Dossiers: Internal Fossil Fuel Industry Memos Reveal Decades of Corporate Disinformation*, 2015, p. 9. (<http://www.ucsusa.org/sites/default/files/attach/2015/07/The-Climate-Deception-Dossiers.pdf>)

cent actions include sponsoring an advertising campaign against climate legislation in 2009,<sup>24</sup> fighting the EPA's new carbon pollution regulations in 2011,<sup>25</sup> and opposing the recent Clean Power Plan.<sup>26</sup> Furthermore, their statement on the science of climate change, that “emissions from their [oil and natural gas] production and use may be helping to warm our planet by enhancing the natural greenhouse effect of the atmosphere”<sup>27</sup> is much less confident than the IPCC's language, which states that “[m]ost of the observed increase in global average temperatures since the mid-20th century is *very likely* due to the observed increase in anthropogenic greenhouse gas concentrations,”<sup>28</sup> with “very likely” defined specifically as having a probability of occurrence greater than 90 percent.<sup>29</sup> While this does not mean that the API is necessarily a climate change “denier,” it shows some “skepticism” of the IPCC and general scientific community, and this view of the science certainly helps their opposition to climate action.

Fossil fuel trade associations in general, including those outside the United States, such as the Canadian Association of Petroleum Producers and the Australian Coal Association, have been noted to “often campaign against measures that would cut [greenhouse gas] emissions, or run campaigns in support of unfettered fossil fuel energy.”<sup>30</sup> Without counting overlaps with the API, the Canadian Association of Petroleum Producers represents an additional 14 oil and gas companies on the top 200 list. Additionally, a coal association in the United States, the National Mining Association, which represents another 11 companies on the top 200 list, including one of Carleton's direct holdings (Consol Energy), has opposed recent measures from the Clean Power Plan that seek to reduce emissions necessary to ease the transition to a low carbon future.<sup>31</sup>

All of the actions described here are examples of delaying action on climate change, prolonging the life span of the fossil fuel industry, and gambling with the health and security of present and future people and ecosystems.<sup>32</sup> In this sense, fossil fuel companies have not done all they could do to help stick to the 2°C limit and to make the transition as quickly and efficiently as possible; they have not been the responsible stakeholders the world needed and needs to address our climate problem. We find it troubling to profit from companies that are so committed to the traditional business model of extracting and selling fossil fuels that their actions threaten the success of the 2°C global climate goal. We therefore feel that it is ethically problematic to hold these fossil fuel stocks in our endowment.

<sup>24</sup> Union of Concerned Scientists, *A Climate of Corporate Control: How Corporations Have Influenced the U.S. Dialogue on Climate Science and Policy*, 2012, p. 4. ([http://www.ucsusa.org/sites/default/files/legacy/assets/documents/scientific\\_integrity/a-climate-of-corporate-control-report.pdf](http://www.ucsusa.org/sites/default/files/legacy/assets/documents/scientific_integrity/a-climate-of-corporate-control-report.pdf))

<sup>25</sup> Union of Concerned Scientists, *The Climate Deception Dossiers: Internal Fossil Fuel Industry Memos Reveal Decades of Corporate Disinformation*, 2015, p. 9. (<http://www.ucsusa.org/sites/default/files/attach/2015/07/The-Climate-Deception-Dossiers.pdf>)

<sup>26</sup> “Oil and gas bodies respond to Clean Power Plan.” (<http://www.energyglobal.com/downstream/clean-fuels/04082015/Clean-Power-Plan-responses/>)

<sup>27</sup> “Climate Change.” (<http://www.api.org/environment-health-and-safety/climate-change>)

<sup>28</sup> IPCC, *Climate Change 2007: The Physical Science Basis*, 2007, p.10. ([http://www.ipcc.ch/pdf/assessment-report/ar4/wg1/ar4\\_wg1\\_full\\_report.pdf](http://www.ipcc.ch/pdf/assessment-report/ar4/wg1/ar4_wg1_full_report.pdf))

<sup>29</sup> *Ibid.*, p.3.

<sup>30</sup> Greenpeace, *Who's holding us back? How carbon-intensive industry is preventing effective climate legislation*, 2011, p.19. (<http://www.greenpeace.org/international/Global/international/publications/climate/2011/391%20-%20WhosHoldingUsBack.pdf>)

<sup>31</sup> “Coal Interests Prepare To Challenge Obama's Power Plant Rules” ([http://www.huffingtonpost.com/entry/obama-power-plant-rules-challenges\\_55bf9689e4bod4f33a036802](http://www.huffingtonpost.com/entry/obama-power-plant-rules-challenges_55bf9689e4bod4f33a036802))

<sup>32</sup> For more on specific instances of misinformation, lobbying, and obstruction of climate action, see <http://www.fossilfreemit.org/wp-content/uploads/2014/08/FossilFreeMIT-Lobbying-Disinformation.pdf>.

## 2.2 Effectiveness and Impact of Our Recommendation

We are cautiously optimistic that divestment is an effective strategy to help reduce global warming. We view it as one tool in a toolkit of sustainability-related measures that Carleton is already engaged in. The divestment movement is growing (see §2.6), and has been receiving increased media attention and general visibility. This movement helps to build support for real action on climate change by shifting public perception, reducing the industry's social license to continue contributing to an unsustainable carbon economy, and creating the space for real alternatives to fossil fuels.

We do not see divestment as a means of directly weakening the stock of these companies, nor as a means to drive these companies out of business. Rather, we believe that divestment will create an atmosphere in which the current political capital of fossil fuel companies is reduced so that carbon emissions can become more effectively regulated and controlled, for instance through the imposition of a carbon tax. We feel in general that a strong and growing divestment movement can help move the conversation in a positive and necessary direction by emboldening government and society to take action.

We believe that history shows the effectiveness of divestment, in particular with respect to the divestment campaign Carleton joined from the 1970s through the 1990s—that of divestment from companies doing business in South Africa (see §2.5). In the words of Adele Simmons, former president of the John D. and Catherine T. MacArthur Foundation: “When I met F.W. de Klerk, the last president of the apartheid regime, in Chicago two years ago, he was clear: ‘When the divestment movement began, I knew that apartheid had to end.’ And when I met with Mandela in 1990 in New York, he said that divestment was a crucial factor in ending apartheid.”<sup>33</sup>

CRIC has also considered and discussed the strategy of shareholder engagement, long one of CRIC's methods of influencing corporate behavior, as an alternative to divestment. Given the centrality of the extraction of fossil fuels to the business model of these companies, the absence of any track record of success in this area in recent decades, and the severity and scope of the climate-change crisis, we feel that shareholder engagement is far less effective than divestment, with its potentially paradigm-shifting impact.<sup>34</sup>

Divestment, furthermore, has added potential impacts and benefits compared to ESG investing. One benefit is that divestment is an action that can be implemented quickly and could help to generate support for addressing climate change in the near term. ESG on the other hand won't be able to be implemented instantly because it requires time to develop an integration strategy. Another benefit is that the divestment movement is a movement that directly targets climate change. ESG on the other hand, is concerned with multiple different issues and has not primarily focused on climate change. Figuring out how to integrate all these issues adds layers of complexity and it is unclear how much one issue can dominate in ESG integration. Divestment simplifies its target issue and is therefore more focused and directed toward climate change than ESG is.

Finally, divestment has an advantage over ESG in that it does try to accelerate the implementation of climate policy and regulation. This is its ultimate goal and intended effect, but its more immediate effects help reach the ultimate goal. Divestment, unlike ESG investing, has the real ability to shift the social and political consciousness on the issue of climate change and climate change regulation. This is because divestment is more than an investment decision; it is also a means of communication. Divestment amplifies the message of the need for climate change action. It also tries to make fossil fuel companies socially

<sup>33</sup> “Outside Opinion: Skeptics were wrong; South Africa divestment worked.” ([http://articles.chicagotribune.com/2013-12-15/business/ct-biz-1215-outside-opinion-20131215\\_1\\_sullivan-principles-south-africa-outside-opinion](http://articles.chicagotribune.com/2013-12-15/business/ct-biz-1215-outside-opinion-20131215_1_sullivan-principles-south-africa-outside-opinion))

<sup>34</sup> Green Century Funds, “The Power and Limits of Shareholder Advocacy with Fossil Fuel Companies,” 2013. (<http://greencentury.com/wp-content/uploads/2013/10/Power-and-Limits-of-Shareholder-Advocacy-wrt-Fossil-Fuels-2013.pdf>)



accountable for their obstructions to such actions and calls on them to be responsible stakeholders. Historically, divestment and boycott movements have been important and effective tools for public persuasion, and this public persuasion and understanding can be leveraged to change laws.<sup>35</sup> This is part of the climate solution along with the incorporation of ESG risks on the investment side of the issue (as mentioned in §1.3 of the ESG section).

## 2.3 Financial Aspects and Risks/Benefits of Divestment

After significant consideration and discussion with Jason Matz, we decided not to commission a Carleton-specific study on the financial costs or benefits of divestment. A truly useful study would have required significant data collection and sustained analysis, and would have been prohibitively expensive according to estimates from Cambridge Associates. A more general (non-Carleton-specific) and less expensive study would likely not have given us particularly clear or helpful data which could not be already found elsewhere.

So instead we looked into more general studies that have been undertaken, and here Jason Matz and the Carleton Investment Office helped us with guidance and references. A review of these works shows that the risk of divestment varies based on the timeframe for which one examines past performance: studies in the 5-10 year range show higher returns for a fossil-free portfolio; studies in the 10-20 year range tend to show neutral performance; and studies assessing performance of fossil-free portfolios over the past 20-50 years show lower returns than those portfolios that included fossil fuel investments.

### 2.3.1 Evidence that Divestment Would Not Affect, or Would Help, Endowment Performance

In our research, we came across a number of studies that assert divestment would have either no effect or a positive effect on endowment performance. One such study, done by Aperio Group, estimated a trivial 0.0034% theoretical return penalty from full divestment and found that a “full carbon divestment” portfolio outperformed the Russell 3000 benchmark in 73% of ten-year periods over a 22-year historical analysis.<sup>36</sup> Another 22 year analysis by Advisor Partners found that the “simulated performance of [a] full divestment portfolio was virtually indistinguishable from that of the S&P 500 index.”<sup>37</sup>

A shorter-term analysis—five years, since 2008—by MSCI found that the portfolio formed by removing fossil fuels from the MSCI All Country World Index Investable Market Index (ACWI IMI) closely tracked the MCSI ACWI IMI, but that the active return differential over the entire time series was 1.2% in favor of the fossil free portfolio. Over ten years, the fossil-free portfolio would have lost .16%.

Two other studies looking at the short term, five to ten years, show positive results from fossil-free portfolios. One, done by S&P Capital IQ, found that over the past ten years, a \$1 billion endowment with no fossil fuel investments would have yielded \$119 million more than an endowment with typical fossil investments. The second, from Impax Asset Management, looked at the past five years and found that portfolios containing significant investment in renewables and efficiency and no investment in fossil fuels tend to perform better than a typical portfolio—a 1.8% vs 2.2% or 2.3% increase, depending on the nature of the renewables investments.<sup>38</sup>

<sup>35</sup> Stephen Coll in panel discussion, “A Safe Future for Fossil Fuel Investments in a Carbon-Constrained World?” hosted by Columbia Law School, 2015. (<http://ccsi.columbia.edu/2015/07/09/a-safe-future-for-fossil-fuel-investments-in-a-carbon-constrained-world/>)

<sup>36</sup> Aperio Group, *Do the Investment Math: Building a Carbon-Free Portfolio*, 2013, p.3. ([http://gofossilfree.org/se/wp-content/uploads/sites/13/2014/07/building\\_a\\_carbon\\_free\\_portfolio.pdf](http://gofossilfree.org/se/wp-content/uploads/sites/13/2014/07/building_a_carbon_free_portfolio.pdf))

<sup>37</sup> Advisor Partners, *Fossil Fuel Divestment: Risks and Opportunities*, 2013, p. 3. ([http://www.advisorpartners.com/uploads/4/8/5/3/48535043/fossil\\_fuel\\_study\\_\\_07-9-13.pdf](http://www.advisorpartners.com/uploads/4/8/5/3/48535043/fossil_fuel_study__07-9-13.pdf))

<sup>38</sup> Fossil Free Stanford, *The Case for Fossil Fuel Divestment at Stanford University*, p. 10. (<http://www.fossilfreestanford.org/upl>)

### 2.3.2 Evidence that Divestment Would Negatively Affect Endowment Performance

In *Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy*, Professor Daniel Fischel asserts that investors who divest from fossil fuel holdings could potentially face three types of costs: 1) Trading Costs: the costs necessarily associated, through payments to brokers, with buying and selling stocks; 2) Diversification Costs: the costs associated with limiting potential investments and thus suffering from the lost benefit of a fully diversified portfolio; and 3) Compliance Costs: the costs associated with the continual need to identify the specific holdings from which you must divest in order to meet the desired standards of divestment.<sup>39</sup>

Taking these costs into account, Fischel studied the impact divestment would have had on portfolios across ten different sectors from 1965-2014. He found that, overall, fossil-free portfolios would have had returns 0.7% lower than those which included fossil fuel investments. Thus, Fischel found that divestment would have a negative impact on endowment performance.

Similarly, a study conducted by Timothy Adler and Mark Kritzman, which was published in the Fall 2008 *Journal of Portfolio Management*, found that fossil-free portfolios would have underperformed portfolios that include fossil fuels by 0.3%. Their study looked at investments over the past 20 years.<sup>40</sup> However, in a report by Julie Goodman for Northstar Asset Management, she calls into question the results of Adler's and Kritzman's analysis. In *To Paraphrase Mark Twain: The Cost of Fossil Fuel Divestment Has Been Greatly Exaggerated*, Goodman asserts that the penalty faced by fossil-free portfolios is actually closer to 0.15%.<sup>41</sup>

### 2.3.3 Other Considerations

Ultimately, though studies of how divestment from fossil fuel companies would have affected past performance appear to potentially support a low-risk conclusion, it is difficult to accurately assess what financial effect divestment from fossil fuels would have on future performance, given we cannot predict how political and/or societal changes may affect the market. However, there is one more potential argument in favor of fossil fuel divestment that affects financial risk, and thus bears discussion here: the stranded carbon assets argument.

There is a general consensus that, in order to remain below a 2°C target, we must limit concentrations of atmospheric CO<sub>2</sub> to 450 parts per million (ppm) or lower, meaning roughly 80% of proven fossil fuel reserves will need to be left in the ground. To achieve this target, many believe that the global community will need to enforce a carbon budget through regulation and reorienting of market forces. The enforcement of a carbon budget would cause current fossil fuel reserves to become “stranded carbon assets,” resulting in lower valuations of these reserves. This risk would be concentrated especially among the top 200 companies due to their large reserves. Stranded assets would impose significant financial risk to fossil fuel companies and endowments holding stock in them.

There is however a debate about whether stranded assets do actually pose a financial risk to endowments in the short term. The assumption that the current fossil fuel companies' valuations are overstated because of unburnable carbon reserves due to a carbon budget may not be necessarily true if the markets are already fully aware of this risk. In the short term, such companies are going to find adequate demand

oads/2/3/4/0/23400882/\_the\_case\_for\_fossil\_fuel\_divestment\_at\_stanford\_university.pdf)

<sup>39</sup> Daniel R. Fischel, *Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy*, 2015. ([http://divestmentfacts.com/pdf/Fischel\\_Report.pdf](http://divestmentfacts.com/pdf/Fischel_Report.pdf))

<sup>40</sup> Timothy Adler and Mark Kritzman, “The Cost of Socially Responsible Investing” in *Journal of Portfolio Management*, Vol. 35, No. 1 (Fall 2008): 52-56.

<sup>41</sup> Northstar Asset Management, *To Paraphrase Mark Twain: The Cost of Fossil Fuel Divestment Has Been Greatly Exaggerated*, 2013. ([http://www.mayorsinnovation.org/images/uploads/pdf/FINAL\\_Revised\\_NorthStar-Cost\\_of\\_Divestment.pdf](http://www.mayorsinnovation.org/images/uploads/pdf/FINAL_Revised_NorthStar-Cost_of_Divestment.pdf))

for their products at reasonable enough prices to make it profitable to extract from their reserves, even with a carbon budget. But the issue of not knowing precisely when a carbon budget will be implemented and when the financial viability of fossil fuel companies will suffer would make it difficult to calculate the risk precisely. In any case, the stranded assets argument is something that came up often in the literature and something that should at least be considered when going forward.

#### 2.3.4 Conclusions

At this time, we are only considering what effect fossil fuel divestment would have on Carleton's direct holdings. As of June 2015, only \$4,312,998 out of our total direct holdings of \$135,602,516 (3.2%) was invested in fossil fuel companies, or roughly 0.54% of our approximately \$800 million total endowment. Relatedly, we believe that limiting the possible investment spectrum with respect to 0.54% of our endowment will likely not expose Carleton to undue additional risk, and also should not pose a significant threat to Carleton's ability to hedge against inflation. Thus, we predict that the financial risk of fossil fuel divestment from Carleton's direct holdings is bound to be relatively low, if not negligible.

### 2.4 Thinking through the Political Nature of Divestment

We very much appreciate the Investment Committee's hesitation to engage in any activity that might politicize the endowment. We recognize that climate change has become highly politicized in this country and that both acknowledging it and the manner of addressing it are intensely political. But we feel that Carleton has a) already taken a political position on this issue, and b) the enormity of the issue transcends political considerations.

a) Carleton has already engaged in actions that could be construed as political surrounding climate change. The signing of the ACUPCC in 2007 explicitly acknowledges global climate change and the need to take aggressive action to combat it. Our goal of carbon neutrality does the same. In general, divestment from fossil fuels is essentially an action based on ethics, not politics. However, in some instances, ethical decisions can have important political implications. For example, the abolition movement based on the moral abhorrence of slavery led to political outcomes that eventually brought an end to the practice. Ethical decisions should not be avoided because they may have political implications. This, in fact, may strengthen the rationale for action since the ethical decision may play a part in bringing about a change in policy which addresses an unethical situation. In the case at hand, our ethical decisions would be motivated by the need to do all we can to address climate change, which may also have policy implications.

Furthermore, if divestment is a political act, then, given the context of climate change, so is not divesting. The political message of not divesting is that climate change is not a sufficiently urgent problem to apply all possible pressure for action and that the behavior of the fossil fuel industry does not rise to a level of ethical compromise deserving of college action. At this point the college cannot avoid making some kind of statement on climate change and fossil fuel investments, either explicitly or tacitly.

b) We feel the need to address climate change is one of the paramount ethical issues of our time, similar to that of apartheid a generation ago. An issue of this importance is rare, and requires an extraordinary response. The Trustees chose divestment in the 1980s, and we hope they will do so again in 2015. We do not see the danger of a "slippery slope," as issues of this magnitude come along infrequently. Some relevant points in this context:

- The **extent of negative impacts** resulting from a high carbon future is huge and dwarfs the impacts of any other business activities in the portfolio. Scientists assure us that a continuation of our current

path will lead to calamitous impacts on human life across the planet and on the natural environment. The potential scale of damage is truly global and, as described by the Intergovernmental Panel on Climate Change (IPCC) will likely be “severe, pervasive, and irreversible.”

- There is also an **urgency** to this issue that may well not be present with other issues. We have already delayed doing anything significant for over 20 years. Time is truly running out on our attempts to prevent the worst of likely future impacts.
- There is a particularly **significant justice issue** related to climate change. The impacts will be felt differentially by those who have had little or no voice in creating the problem or addressing it. Those who have not done much to cause the problem will be most impacted. Impacts will fall disproportionately on the global poor, the natural environment, and on future generations. This is an ethical problem unmatched by any other issues.
- The creation of a high carbon future resulting from business as usual is not a side effect of the fossil fuel companies business like, say, their behavior in a certain country, or their treatment of unions, etc. **High carbon is at the heart of their business.**
- The **size and economic power of the fossil fuel industry is enormous.** This economic power, especially given current campaign finance laws, gives it a tremendous ability to influence policy decisions, public perceptions, and election results. This makes divestment, as an ethical statement against the behavior of these companies, extremely important.
- There is a **powerful and growing global movement** that Carleton can join and help lead. Because it can be a leader in this movement by divesting, Carleton has the opportunity to help change the national conversation on fossil fuels and the future.
- Carleton has already clearly recognized the problems associated with a high carbon future and has taken laudable steps to reduce the college’s carbon footprint. This makes the climate change issue different from most other ethical issues. **We recognize the problem and have taken some steps to address it**, but these are inadequate for a global solution. Even if every college in the country went green, it would not likely make a dent in the problem. But if every college divested from fossil fuel stocks for ethical reasons, it would certainly change the national conversation and might spark significant changes in policy. We face a particular ethical dilemma with respect to fossil fuels: we support a low carbon future on campus, but bet on and create our own vested interest in a high carbon future with our investment policy. This is not right and is not likely to apply to other stock holdings.

## 2.5 History of Divestment

As we described in our February 2015 annual report, current discussions over fossil fuel divestment echo debates from the 1970s and 1980s over divestment from companies doing business with apartheid-era South Africa. Carleton developed a policy commonly referred to as “selective divestment,” which based the decision to divest on the Sullivan Principles. By the late 1980s, Carleton had divested nearly \$20 million (of an endowment valued at \$175M in 1990) in government bonds and equities of financial institutions involved directly with the regime.<sup>42</sup> Of note is that Nelson Mandela came to the United States upon his release from

<sup>42</sup> Stephen R. Lewis, Jr., “Lewis Explicates South African Investment Policy.” *Carletonian*, May 12, 1989, p. 5; “Reatha Clark King to Head Carleton Effort to Help Educate Black South Africans.” Carleton College press release, October 31, 1989.

prison to personally thank students who supported divestment; today, the anti-apartheid activist Desmond Tutu has called for fossil fuel divestment with the belief that we can arrest climate change using the tactics that were successful in South Africa.<sup>43</sup>

## 2.6 How other schools have approached the divestment issue

The divestment movement is active on hundreds of campuses throughout the world, and currently roughly three dozen schools have chosen to divest, including most recently Syracuse University with its \$1.8 billion endowment.<sup>44</sup> These schools have broadly reasoned that holding fossil fuel stocks is ethically problematic, the symbolic impact of divestment is potentially large and effective, and the costs would be minimal. Generally speaking, these schools have treated divestment as one aspect of larger institutional commitments to sustainability and energy efficiency.

Many schools have chosen not to divest, and our committee looked at a handful of peer institutions (Bates, Middlebury, Pomona, Smith, and Swarthmore) as well as several leading research universities (Harvard, Yale, Tufts) to understand their decisions. All foregrounded fears that divestment would affect endowment returns, though most based this conclusion on divestment from commingled funds or on replacing the divested equities with passive investments, neither of which is a factor relevant to our recommendation related to actively-managed direct investments. Much as your March 3 letter highlighted, school leaders and trustees also feared making social or political statements with respect to their endowments, and questioned the effectiveness and end goal of divestment. We hope the foregoing sections have addressed these points with respect to Carleton.

## 2.7 From Which Companies to Divest? (including a minority opinion statement)

### 2.7.1 Divestment from the top 200 fossil fuel companies

The “top 200” list of coal, oil, and gas companies ranks public companies by the potential carbon content of their reported reserves. It is made up of the largest 100 coal companies and the largest 100 oil and gas companies, in terms of their reserves, and is reported through the Carbon Underground Project (CUP).<sup>45</sup> The index is used by the divestment movement as well as by many individual and institutional investors and financial advisors. The list is a dynamic one in that it is updated each year to reflect changes in the carbon reserves of particular companies. The total potential carbon content of these reserves has risen from 503 gigatons in 2010 to 555 gigatons in 2014. We believe that, while not perfect, this list is an appropriate instrument since many companies on the list are connected to unethical behaviors and the overwhelming majority of these reserves must be left in the ground, which these companies show no sign of doing.<sup>46</sup>

One critique that comes from opponents of divestment is that divesting from companies punishes those who may want to explore transitioning their core business model away from fossil fuels and toward renewable energy sources. However, we find this critique does not hold much weight when one examines how the CUP list of “top 200” coal, oil, and gas companies is created. If a coal, oil, or gas company were to transition its core business model, and therefore its assets, from fossil fuels to renewable energy technologies, the known fossil fuel reserves held by the company would decline and the company would drop off

<sup>43</sup> Fossil Free Stanford, *The Case for Fossil Fuel Divestment at Stanford University*, p. 4-6. ([http://www.fossilfreestanford.org/uploads/2/3/4/0/23400882/\\_the\\_case\\_for\\_fossil\\_fuel\\_divestment\\_at\\_stanford\\_university.pdf](http://www.fossilfreestanford.org/uploads/2/3/4/0/23400882/_the_case_for_fossil_fuel_divestment_at_stanford_university.pdf))

<sup>44</sup> “Divestment Commitments.” (<http://gofossilfree.org/commitments/>)

<sup>45</sup> “The Carbon Underground 2015.” ([www.fossilfreeindexes.com/research/the-carbon-underground](http://www.fossilfreeindexes.com/research/the-carbon-underground))

<sup>46</sup> “Shell’s future energy scenarios don’t see the 2°C objective being met.” (<http://www.shell.com/global/future-energy/inside-energy/inside-energy-stories/urging-action-to-fight-climate-change.html>)

the list at some point and would no longer be a target of divestment efforts. Institutions that had previously divested from such a company would no longer be in conflict with their goals for divestment if they chose to reinvest in such companies.

If Carleton wanted to use a more stringent definition, it could apply the three principles described below to any fossil fuel company, regardless of the size of their reserves. The CUP list focuses the question on the biggest holders of reserves and makes for more manageable and uniform data collection and analysis. For a company still on CUP's top 200 list to be removed from Carleton's divestment campaign, we would suggest the following metric:

- That it stop political efforts (lobbying and candidate funding) to protect subsidies and to prevent or slow significant state, national, and global efforts to move to a low carbon future. It should stop efforts to fund attacks on the mainstream science of climate change. And it should shift the tremendous financial and technical resources controlled by the company to the search for and support of significant solutions to the climate crisis.
- It should stop using capital expenditures to explore for new carbon sources, or to develop infrastructure or technologies to facilitate the exploitation of hard to recover reserves.
- Most importantly, it should commit to and show evidence of implementing a business plan which will leave significant portions of their carbon assets unused on Earth.

These metrics are consistent with a 2°C target and therefore with Carleton's climate goals. We believe that any fossil fuel company following these criteria would be acting as responsible stakeholders in addressing the climate challenge.

### 2.7.2 Minority opinion statement: Divesting from the top 100 coal companies

The lone opposing view about divesting the Carleton endowment from the top 200 fossil fuel companies is also a call for divestment of the endowment. However, it is a call for divestment from directly held stocks of only the top 100 coal stocks rather than the fossil fuel stocks that the majority view supports:

Divestment, in my opinion, is a symbolic gesture which will announce to everyone that Carleton is serious about the need to change behaviors of individuals, companies, and the legislature with an end goal to create a rapid, dramatic, and cost-effective transition to a low-emissions economy.

So why my call to divest from just coal-mining and not all fossil fuel companies? The endowment return is critical to Carleton's long-term future and I would prefer that the risk of the divestment action not have any impact on the returns the College needs to continue to support the academic focus of Carleton's mission. Coal companies make up less than 1 percent of major public market indexes and haven't been performing well lately.

Additionally, at this time, there is no precise way to determine which fossil fuel companies are promoting misinformation and not working to lower carbon expenditures. Individuals are still reliant on fossil fuels and stigmatizing these companies for giving us what we need will not help us reach our goals. We do know, however, that moving from coal to oil would have a significant impact on emissions.

As John Hennessy, the president of Stanford University, which divested from coal in May of 2014, said: “In the medium- to long-term, the United States doesn’t need to rely on coal, because the United States has ample reserves now of natural gas, in particular. We think it would be better for the country to move in that direction as quickly as possible.”<sup>47</sup> That’s because burning coal to generate electricity emits more carbon dioxide and smog-causing pollutants than does burning other fossil fuels, such as natural gas.

Pairing divestment from coal-mining stocks with ESG (Environmental, Social, and Governance) investment practices will allow us to make a dramatic statement NOW about the world’s need to reduce carbon emissions. Going forward, as evaluation instruments are developed to reveal the fossil fuel companies’ practices and intentions, we will be able to leverage ownership in the stocks by use of proxy voting techniques to pressure changes that would reduce greenhouse-gas emissions from gas production. Or, we may decide, based on our data, to not continue to hold a particular stock.

I agree with all other statements in this document by CRIC.

Sincerely,

Melissa J. Thomas

Special Events Associate and Administrative Assistant for College Communications

### 3 Conclusion

We feel there is a clear and compelling case for both integrating an ESG investment strategy as well as divesting from the top 200 fossil fuel companies. Stated succinctly:

- There is a major crisis underway, with significant and looming effects on the earth and its people. We need to take significant steps in the near future to achieve a comprehensive solution, and to do it we need civil society, government, and the market to work together.
- ESG investing is a crucial component in the financing and transitioning to a low carbon future and in our attempts to stay under the 2°C limit. This is especially true given its broad reach and use of competitive market forces to help allocate investments efficiently with respect to climate risk.
- Divestment in addition to ESG investing can enhance the climate change-mitigating effects of ESG investing. Political shifts and a greater threat of climate regulations will heighten the importance of climate change risk for investors, resulting in even greater incentives for companies to reduce greenhouse gas emissions
- Fossil fuel companies play a major role in exacerbating the climate crisis and preventing our ability to address it. Their core business model is directed to extracting and burning carbon beyond the limits the earth can support. They fund politicians that deny climate change and support climate denial more broadly.

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<sup>47</sup> “The Truth About Stanford’s Coal Divestment.” (<http://www.newrepublic.com/article/117871/stanfords-coal-divestment-s-hows-environmental-hurdles-ahead>)

- Divestment can work and is potentially powerful. Carleton College has previously been significantly involved with a successful divestment movement.
- The financial risk of divestment to the Carleton endowment is small to none, and divestment may even be beneficial.

We therefore recommend to the Investment Committee that it:

- (1) Thoroughly explores the possibility of ESG integration into Carleton's investment strategy as well as the creation of a formal ESG investment policy, with particular emphasis on climate change-related ESG issues.
- (2) Engage directly with our external investment managers and ask them to focus more on climate change-related risks and performance indicators when making investment decisions.
- (3) Divest from fossil fuel direct holdings in our endowment.

We thank the members of the Investment Committee for their consideration of this issue of importance to students, faculty, staff, alumni, and trustees.



## 4 Appendix

David Swensen, Yale's chief investment officer, wrote the following letter to Yale's external investment managers:<sup>48</sup>

I write to discuss climate change and Yale's investment program. The Investments Office bases its approach to global warming on the conclusion that greenhouse gas emissions pose a grave threat to human existence. Climate change (caused by deforestation and emissions of carbon dioxide, methane and other gases) creates a substantial risk of significant changes to the world's ecosystem and in actions to address those changes, making consideration of the impact of climate change essential when evaluating investment opportunities.

Yale asks that when making investment decisions on the University's behalf, you assess the greenhouse gas footprint of prospective investments, the direct costs of the consequences of climate change on expected returns, and the costs of policies aimed at reducing greenhouse gas emissions on expected returns. Simply put, those investments with relatively small greenhouse gas footprints will be advantaged relative to those investments with relatively large greenhouse gas footprints.

A full accounting of the internal and external costs of greenhouse gas emissions will call into question the business models of some investments, which will require especially careful consideration. Today, examples include thermal coal producers, tar sands operations, companies that rely on cheap power from coal and low-lying coastal real estate. Of course, the list of investments requiring special consideration will change along with changes in the population of investments with business models that rely on mispriced externalities.

Conversely, fully pricing the externalities created by greenhouse gas emissions will create opportunities for profit. Examples include companies that produce renewable energy and products that facilitate demand shifting or otherwise promote efficient use of energy.

With respect to the particular case of investments in corporate entities, as you consider the implications of climate change, Yale expects you to discuss with company managements the financial risks of climate change and the financial implications of current and prospective government policies to reduce greenhouse gas emissions. You should encourage managements to mitigate financial risks and to increase financial returns by reducing greenhouse gas emissions. Yale asks you to avoid companies that refuse to acknowledge the social and financial costs of climate change and that fail to take economically sensible steps to reduce greenhouse gas emissions.

Government policies addressing climate change will impose costs on many investments, especially those with relatively high greenhouse gas footprints. If countries around the world implement pricing schemes that reflect the true costs of greenhouse gas emissions and if in your investment decisions you properly account for the costs and risks of greenhouse gas emissions, Yale's investments will be well positioned to deal with a more enlightened regulatory environment. On the other hand, even if governments adopt imperfect policies to control greenhouse gas emissions, the University's position will be protected by accounting for the financial impact of these policies on portfolio investments. Even in the absence of effective

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<sup>48</sup> "David Swensen on the Fossil Fuel Divestment Debate." (<http://www.cfapubs.org/doi/full/10.2469/faj.v71.n3.3>)

government policies to mitigate greenhouse gas emissions, your consideration of the costs and risks of climate change should lead you to better investment decisions.

Analyzing the greenhouse gas emissions associated with investments is far from simple and fraught with challenges. As in all aspects of investment analysis, decisions will be based on incomplete, imperfect information. That said, consideration of the risks associated with climate change should produce higher-quality portfolios.