

# Sentinel Sustainable Funds: Our Perspective on Fossil Fuel Investing



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The question of how or even if to invest in fossil fuels has been receiving a great deal of attention of late. The global call to reduce greenhouse gas (“GHG”) emissions primarily from fossil fuels is becoming more urgent as the effects of climate change are being felt more acutely around the world, from severe droughts to catastrophic floods.

At the risk of over-simplifying a problem of such staggering complexity as climate change, we will focus here on some of the key issues as well as our approach as sustainable investors to investment in fossil fuel companies in light of climate change.

While our perspective on this issue is that of sustainable investors, this is an important issue facing investors of all stripes.

## Background

The evidence is clear: climate change is real, with real implications. We are seeing its effects from rising sea levels and increasing temperatures to melting ice caps and the number and frequency of extreme weather events around the globe. Studies from the International Energy Agency (“IEA”) and the UN-sponsored Intergovernmental Panel on Climate Change (“IPCC”) point to this phenomenon:

Warming of the climate system is unequivocal, and since the 1950s, many of the observed changes are unprecedented over decades to millennia. The atmosphere and ocean have warmed, the amounts of snow and ice have diminished, sea level has risen, and the concentrations of greenhouse gases have increased.<sup>1</sup>

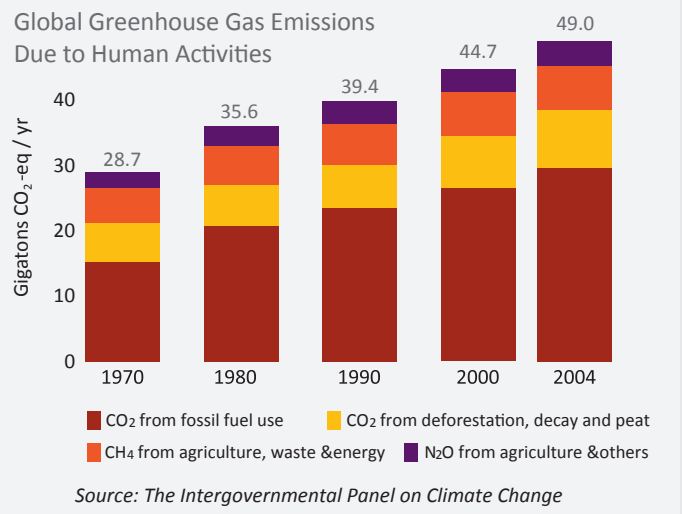
The primary source of the increased GHG emissions has been identified as fossil fuels.

The atmospheric concentrations of carbon dioxide, methane, and nitrous oxide have increased to levels unprecedented in at least the last 800,000 years. Carbon dioxide concentrations have increased by 40% since pre-industrial times, primarily from fossil fuel emissions...<sup>2</sup>

From the Kyoto Protocol established in 1997 to the Warsaw Climate Change Conference in 2013, the international community has been struggling to address climate change and to limit

carbon emissions. A major step forward was made with the 2009 Copenhagen Accord, when international agreement was reached to limit global warming based on the IPCC’s fourth assessment:

To achieve the ultimate objective of the Convention to stabilize greenhouse gas concentration in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system, we shall, recognizing the scientific view that the increase in global temperature should be below 2 degrees Celsius...enhance our long-term cooperative action to combat climate change.<sup>3</sup>



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This commitment was re-affirmed in Cancun in 2010, with the possibility of revising it down to 1.5°C.<sup>4</sup> According to the IEA, in order to have about a 50% chance of achieving the 2°C goal, we would have to limit CO<sub>2</sub> levels in the atmosphere to 450 parts per million (“ppm”).<sup>5</sup>

Unfortunately, we are moving in the wrong direction. “In May 2013, carbon-dioxide (CO<sub>2</sub>) levels in the atmosphere exceeded 400 parts per million for the first time in several hundred millennia.”<sup>6</sup> We are currently at an increase of 0.8°C above pre-industrial levels and based on our current trajectory, we are more likely to see average temperature increases between 3.6°C and 5.3°C.<sup>7</sup> Therefore, it is imperative to work to limit carbon emissions in order to keep the average temperature increase below 2°C.

### Carbon Budget → Carbon Bubble

The time horizon for the climate models in the IPCC’s fifth assessment is through 2100, but the implications of the cumulative effects of CO<sub>2</sub> emissions on climate change go well beyond.<sup>8</sup> Given the cumulative effect of carbon in the atmosphere, a reversal or even slowing of the trend of increasing CO<sub>2</sub> emissions will take concerted global effort. “As the source of two-thirds of global

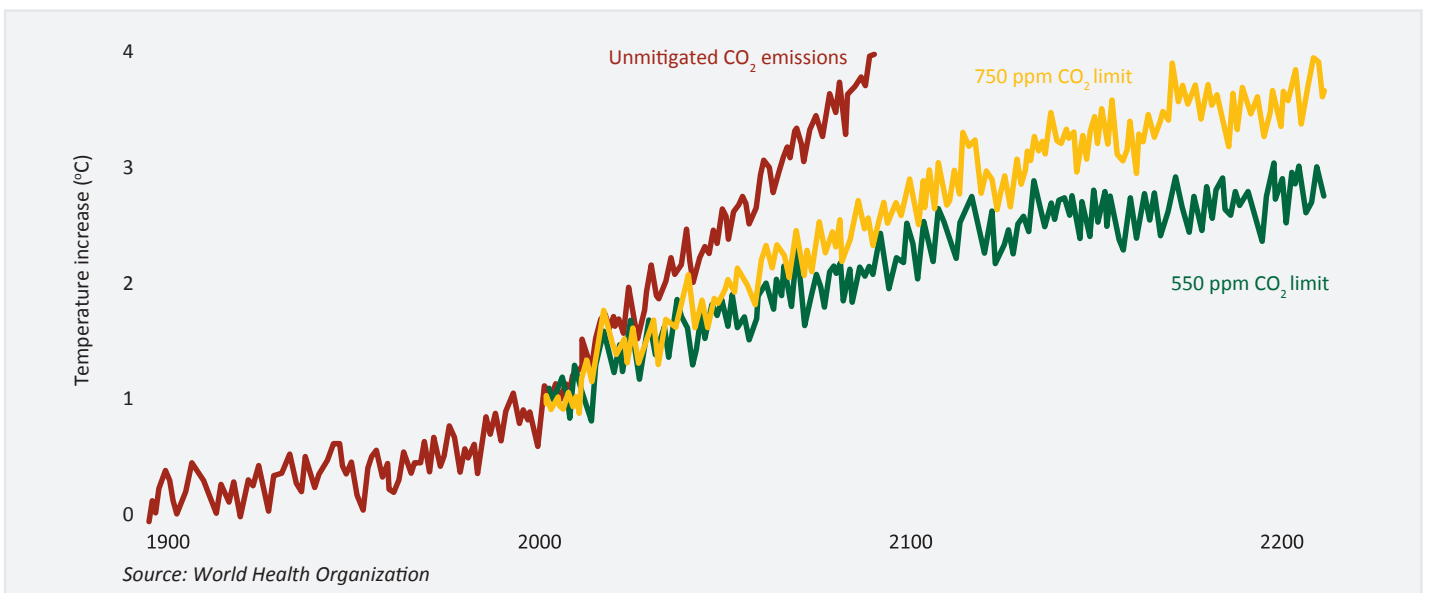
To put the idea of such a budget in perspective, the roughly 884 Gt CO<sub>2</sub> limit is

only a fraction of the carbon embedded in the world’s indicated fossil fuel reserves, which amount to 2,860 Gt CO<sub>2</sub>. A precautionary approach means only 20% of total fossil fuel reserves can be burnt to 2050. As a result the global economy already faces the prospect of assets becoming stranded, with the problem only likely to get worse if the current investment trends continue – in effect, a carbon bubble.<sup>11</sup>

The challenge of limiting carbon in the atmosphere becomes even greater after 2050.

In the absence of negative emissions technologies [e.g. carbon capture and storage], the carbon budget for the second half of the century would only be 75 Gt CO<sub>2</sub> to have an 80% probability of hitting the 2°C target. This is equivalent to just over two years of emissions at current levels.<sup>12</sup>

These projections are sobering at best. With energy needs expected to rise in the coming decades, it is important to manage how those needs are met without placing greater strain on the global



greenhouse-gas emissions, the energy sector will be pivotal in determining whether or not climate change goals are achieved.”<sup>9</sup> Therefore, the focus for effectively combating climate change is on fossil fuels and by extension energy companies.

Analysis has shown that, in order to have a 50% probability of keeping global warming to no more than 2°C, total emissions from fossil fuels and land-use change in the first half of the century need to be kept below 1 440 Gt (Meinshausen, *et al.*, 2009). Of this ‘carbon budget’, 420 Gt CO<sub>2</sub> has already been emitted between 2000 and 2011 (Oliver, Janssens-Maenhout and Peters, 2012) and the *World Energy Outlook 2012 (WEO-2012)* estimated that another 136 Gt CO<sub>2</sub> will be emitted from non-energy related sources in the period up to 2050. This means that the energy sector can emit a maximum of 884 Gt CO<sub>2</sub> by 2050 without exceeding its residual budget.<sup>10</sup>

environment. So the questions become, how do we best curb GHG emissions while meeting global energy demand, and what are the implications for fossil fuel companies?

### An Issue of Risk

We know the risk of inaction is unprecedented climate change, the effects of which are both wide-ranging and potentially devastating, and investors are taking note. A recent global investor survey commissioned by the Networks of the Global Investor Coalition on Climate Change found that “almost 100% of respondents with direct responsibility for managing assets continue to conduct climate risk assessments within asset classes, considering factors such as regulations, corporate governance and physical impacts.”<sup>13</sup> More specifically, a study conducted by the Generation Foundation focused on the impact of climate risk on carbon-intensive asset valuations.

Maintaining the status quo, whereby investors fail to properly account for the risks inherent in owning carbon-intensive assets, will cause the 'carbon asset bubble' to grow until the artificially high valuations for these assets can no longer be sustained.<sup>14</sup>

We also know that actions taken to limit carbon emissions carry their own set of risks to investors of fossil fuel companies. The Generation Foundation's study highlights three key risks: 1) regulation, e.g. carbon pricing and emissions guidelines; 2) market forces, which could drive capital allocation away from carbon-intensive assets to renewable energy and energy efficiency technologies; and 3) sociopolitical pressures, which could "create an environment where carbon-intensive businesses could lose their license to operate."<sup>15</sup> These risks are very real and should be taken into consideration when evaluating the fossil fuel investment decision. Of course, there is always the option to divest.

### The Divestment Debate

The question of whether or not to divest fossil fuel holdings has become a major issue sweeping college campuses and board rooms alike. The debate was ignited, in part, by an article that appeared in the August 2, 2012 issue of *Rolling Stone* by author, lecturer, and founder of 350.org, Bill McKibben. In "Global Warming's Terrifying New Math," Mr. McKibben highlights the urgency of reducing carbon emissions. One of the methods he explores is modeled after the anti-apartheid movement which started on college campuses and spread to municipal and state governments, and called for divestment from companies doing business in South Africa. The movement was largely credited with helping end apartheid in South Africa.<sup>16</sup>

The call for fossil fuel divestment went out and the Fossil Free campaign was launched:

for institutions to immediately freeze any new investment in fossil fuel companies, and divest from direct ownership and any commingled funds that include fossil fuel public equities and corporate bonds within 5 years.<sup>17</sup>

Since the campaign's start, investment committees of university and college endowments as well as numerous municipalities have taken up the issue with varying results. So far, nine colleges and universities and 21 US cities from Seattle, WA to Providence, RI have adopted the divestment route.<sup>18</sup> And the numbers are growing.

### Another Approach

The fossil fuel investment question goes beyond campus and municipal activism, however. Many institutional investors are also looking at fossil fuel investment, but are taking action

in the form of corporate engagement rather than divestment. In September 2013, a coalition of 70 global investors representing approximately \$3 trillion in assets, including California state pension giants CalPERS and CalSTRS, penned letters to 45 of the world's top fossil fuel and electric power companies urging them to "assess the financial risks that climate change poses to their business plans."<sup>19</sup> Those who have signed the letters are long-term investors who see "the world moving toward a low-carbon future in which fossil fuel reserves that companies continue to develop may actually become a liability, which could take a toll on shareholder value."<sup>20</sup>

While oil and gas companies are not expected to change their business models overnight, there are signs of progress. It was recently reported that more than two dozen of the largest corporations in the US, including the big five oil companies, are already factoring a carbon price into their financial plans in anticipation of future carbon price regulation\*.<sup>21</sup> While far from revolutionary, it is a start, as placing a price on carbon emissions has long been considered an effective tool in combating climate change as market forces are brought to bear.

### Sentinel's Perspective

For Sentinel's two sustainable funds, we are taking the approach that recognizes there is still a place for fossil fuel companies in a diversified portfolio, as the world economy is still carbon-based. However, as sustainable investors, our goal is to identify those fossil fuel companies that conduct operations safely and responsibly, are exploring alternatives and beneficial technologies through investments in R&D, are receptive to shareholder engagement, and are, in general, less carbon-intensive. Sentinel's sustainable funds, for example, have not held any coal producer since early 2012.

We also recognize the issue of addressing climate change goes well beyond fossil fuel companies. Through our screening process, we evaluate the efforts of companies across all sectors in their fight against climate change, from financial institutions in their lending practices to manufacturers working to reduce energy consumption to retailers turning to renewable sources of energy. In addition, we know sustainable investing does not end with the decision to invest or not invest. As shareholders, we have the opportunity and responsibility to have our voices heard through various avenues of corporate engagement, including proxy voting.

We know our climate is changing. We know the risks of climate change are real. We know the timing is critical. We know to change the current trajectory, it will take a great, unprecedented, global effort. The challenge is of a scale that is almost impossible to fathom. Yet in the face of all this, we believe, as sustainable investors, that by taking collective action, positive change is possible.

**As shareholders, we have the opportunity and responsibility to have our voices heard through various avenues of corporate engagement, including proxy voting.**

\* Although direct carbon pricing regulation in the US is not imminent, it is not completely out of the question. A bill (S.332) addressing climate change, which included carbon pricing and clean energy provisions, was introduced in the Senate in February 2013.

## A Standard of Stewardship

Stewardship is a serious responsibility that can be measured and proven over time.

That's why we are committed to quality, consistency and sustainable results, counted in years rather than days, weeks or months.

Since its inception on January 12, 1934, Sentinel's Common Stock Fund has demonstrated a prudent, consistent approach to investing which has become the hallmark of our firm.

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7 Ibid.

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13 *Global Investor Survey on Climate Change, 3rd Annual Report on Actions and Progress*, Commissioned by the Networks of the Global Investor Coalition on Climate Change, Prepared by Mercer, 2013, p.7

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15 Ibid., pp.1-2

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