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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

PASSIVE VERSUS ACTIVE ESG INVESTING: HOW A SMALL HEDGE FUND CONVERTS AN OIL GIANT*

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Sustainable investing has grown dramatically over the past decade, as an increasing number of institutional investors and funds incorporate various Environmental, Social, and Governance (ESG) mandates in their asset-allocation criteria. In 2010, the total number of sustainable funds was 1,304 globally, with a combined AUM of $195 billion.[1] By the end of 2021, the Q4 inflows alone amounted to $143 billion, and the sustainable fund universe had ballooned to $2.7 trillion AUM across 5,932 funds.[2] Driven by a continual increase in ESG mandates and investor interest in ESG issues, asset managers have continued to create new offerings as well as repurpose and rebrand conventional products into sustainable ones, launching 598 new sustainable funds just in the fourth quarter of 2021.[3] Based on the trajectory of inflows, the size of this market is now projected to exceed $40 trillion AUM by year end.[4]

With the skyrocketing demand for ESG-compliant investments, a natural question arises as to whether the supply has increased commensurately. After all, investing in ready-made ESG is the most obvious and direct path toward fulfilling ESG mandates in asset allocation. For example,

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many ESG funds limit investments based on fossil fuel exposure and avoid investing in companies exposed to thermal coal or other controversial practices that are particularly emissions-heavy. Given this pattern, we would expect corporations to adjust accordingly.

Indeed, on the corporate side of this equation, firms are increasingly making efforts to comply with ESG criteria based on both institutional and retail pressure. In 2019, Business Roundtable released a new Statement on the Purpose of a Corporation, prefaced by the holistic belief that "*the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all*."[5] This statement, signed by 181 CEOs of America's largest corporation, declares that companies should serve not only their shareholders, but also deliver value to their customers, invest in employees, deal fairly with suppliers, and support the communities and protect the environment in which they operate.

Despite these efforts and incentives, firms are not collectively moving fast enough to make sufficient changes to meet the demand for ESG investments. Bebchuk and Tallarita (2020) finds that the Business Roundtable 2019 Statement "did not represent a meaningful commitment" and the statement was "mostly for show."[6] A recent survey by PwC suggests that leaders in most organizations (nearly three-quarters) were still in the early stages of their ESG journey.[7] So then what are ESG funds to do?

Rather than simply investing in ready-made ESG, funds can also engage in ESG activism, whereby fund managers purchase and actively transform a non-ESG firm by way of shareholder activism. The recent victory of a fledgling activist hedge fund against one of America's most iconic Big Oil companies provides an excellent case in point as to how shareholder activism can be leveraged to materially change how companies approach key ESG issues like the environment and climate change.

Specifically, Engine No. 1's successful "Reenergize Exxon" campaign provides a general blueprint for ESG activism.[8] First, Engine No. 1 was able to identify a perfect target: ExxonMobil, whose poor return on capital were arguably based on decades of denial about the impact of climate change on the company's capital allocation decisions. In fact, the past decade saw ExxonMobil's total shareholder returns—dividends included—languish at −15%, compared to the 271% return provided by the S&P 500.

Second, Engine No. 1 campaigned to gain sufficient proxy support to bring in four new independent directors—all with extensive experience in the energy sector—who would be pivotal in passing subsequent shareholder proposals to address climate risk issues. Its ability to garner support from Exxon's key institutional investors was particularly critical for its success. Engine's alternative board slate gained immediate support from the California State Teachers' Retirement System (CalSTRS), followed by California Public Employees' Retirement System (CalPERS) then the New York State Common Retirement Fund—the three largest pension funds in the US. Furthermore, Exxon's top three institutional shareholders, Vanguard, State Street, and BlackRock, in total owning close to 20% of the shares, also backed Engine's proposal.

In the end, despite holding only 0.02% of Exxon Mobil's shares, Engine No. 1 managed to successfully elect three of its four nominated directors to Exxon's board. During this time, Exxon swiftly responded with commitments to provide updates on efforts to address climate change. Exxon also enhanced its focus on carbon emissions in its capital expenditure decisions and announced

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the formation of a new business segment—Low Carbon Solutions.

Overall, in the six-month period since Engine No. 1 began its campaign, Exxon's stock was up more than 50 percent, beating both the broader market and its close competitor Chevron. On the heels of its success, Engine No. 1 soon launched an ESG-focused ETF which raised $100 million in assets from institutional investors. True to form, instead of solely selecting and excluding stocks based on ESG criteria, this ETF takes an active role in corporate governance and seeks to align the portfolio companies with its ESG goals.

Questions:

- What types of firms are ripe targets for ESG activism? How does the board makeup and ownership structure play a role in this assessment?
- How do you ensure sufficient proxy support to effect necessary changes?
- What concerns may arise from ESG activism? Might there be unintended (and undesirable) consequences?

Notes

[1] The Rise of the Sustainable Fund Market and Its Role in Financing Sustainable Development; United Nations Conference on Trade and Development (Geneva, 2021), United Nations.

[2] Morningstar Global Sustainable Fund Flows: Q4 2021 in Review; Morningstar Manager Research, 31 January 2022.

[3] Morningstar Global Sustainable Fund Flows: Q4 2021 in Review, Morningstar Manager Research, 31 January 2022.

[4] ESG by the Numbers: Sustainable Investing Set Records in 2021; Bloomberg, 3 February 2022.

[5] Statement on the Purpose of a Corporation, Business Roundtable, 2019 (accessed at https://opportunity.businessroundtable.org/ourcommitment/).

[6] Lucian Bebchuk and Roberto Tallarita, 2020. The Illusory Promise of Stakeholder Governance. Cornell Law Review, Vol. 106, 91–178.

[7] Are you ready for the ESG revolution? PwC, 15 June 2021 (accessed at https://www.pwc.com/gx/en/issues/esg/esg-revolution.html).

[8] Reenergize Enron: The Case for Change. Accessed at https://reenergizexom.com/the-case-for-change.

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