Memorandum to the Advisory Committee on Investment Responsibility (ACIR)

October 22nd, 2014

From: Divest Duke

Subject: Fossil Fuels Divestment by the Duke Endowment: Addressing Constraints and Providing Options

1. Introduction and Outline

For the past two years the Divest Duke campaign has advocated for Duke University to divest from the largest publicly listed fossil fuel companies as ranked by the potential carbon emissions content of their reported reserves[1]. Over 100 students have contributed actively to the campaign and over 3500 students have signed a petition in support of this action.

Divest Duke presented a divestment proposal to ACIR in February, 2014. This proposal argued that fossil fuel companies' activities cause substantial social harm, and that publicly removing investments in these companies will have a material effect on alleviating such harm. Specifically, this proposal recommended that:

1) Duke University publicly commits to divest within five years from direct ownership of, and from any commingled funds that include, [long positions in] fossil fuel public equities and corporate bonds, and;
2) Duke University immediately abstains from making new investments in fossil fuel companies.

In this memorandum we review our original argument, and propose additional divestment options based on new research and deliberations. Specifically, we (1) summarize why divestment is an appropriate action for Duke University to undertake; (2) address specific concerns raised by ACIR members with regard to full divestment (i.e. divestment as defined above); and (3) discuss alternatives to full divestment, including divestment from coal alone.

2. Divestment is an Appropriate and Effective Action for Duke University to Take

Divest Duke advocates for divestment on the basis of four core principles: (1) That it is consistent with Duke University's stated philosophy and mission; (2) that it has a high level of support within the University community; (3) that it is likely to make a material difference to climate change policy; and (4) that it is financially and administratively feasible. We turn to feasibility in Sections 3 and 4, and review here briefly the first three principles:

2.1. Divestment is consistent with, and highly complementary to, existing publicly-stated sustainability goals held by Duke University[2].

The University has a laudable goal of carbon neutrality by 2024 and has taken extensive steps towards achieving this. This publicly-stated intent to shift consumption away from fossil fuel derived energy sits uneasily with the University's current willingness to contribute indirectly to the production of such energy through the actions of the Endowment. Divestment ensures that our on-campus actions and our investment actions are publicly aligned.

[1] We refer to 200 publicly traded fossil fuel companies that own a majority of the world's carbon reserves as identified by the Carbon Tracker Initiative. Available online at < http://fossilfreeindexes.com/the-carbon-underground-2014/ >. It is these 200 companies we refer to throughout (except when specified). We consider this list to be a guide, rather than strictly prescriptive.

[2] The Sustainable Duke website features the following mission statement: "Duke University seeks to attain and maintain a place of leadership *in all that we do.* This includes leadership in environmental stewardship and sustainability on our campus, in our medical institutions, *and in the larger community* of which we are a part." (emphasis added) Available online at < http://sustainability.duke.edu/index.php >

2.2. Divestment has broad support within the University community.

As of October 2014, 3564 students have signed a petition, 8 student organizations have formally joined a divestment coalition, and 52 faculty have signed a support letter, all in favor of fossil fuel divestment. The faculty and coalition numbers refer to very new elements of the campaign, and given the initial response, are expected to grow rapidly.

2.3. Divestment is likely to have a material impact on global efforts to address climate change.

Divesting from an industry serves as a public acknowledgement of the undesirable outcomes caused by that industry, and as a refusal to support, directly or indirectly, activities resulting in those outcomes. When respected institutions such as universities make such a public refusal they draw attention to the issue that instigated the divestment, diminish the target industry's social license (their reputation and level of social acceptance), and in doing so, promote legislative and regulatory action. Existing research suggests that divestment will have a material impact on the fossil fuel industry and subsequent climate change policy, and suggests that the role played by a university such as Duke would be highly beneficial. For example:

- Ansar *et al.* (2014)[3] found that almost every past divestment campaign, from tobacco to apartheid to Darfur, was followed by restrictive legislation on targeted industries. They also found that action by *leading American universities* was pivotal in the development of divestment movements, shifts in public and corporate opinion, and subsequent legislation.

- While divestment does not aim to change short-term stock prices specifically, and did not do so during the Apartheid divestment according to Teoh, *et al.* (1999)[4], more recent research by Ding *et al.* (2014)[5] and Hong and Kaperczyk (2009)[6] found that targeted firms in other divestment campaigns have faced higher costs of capital.

- The fossil fuel divestment movement has grown faster than previous divestment campaigns. In a short time it has attracted public support from heads of government, the United Nations and the World Bank (see Section 5). On the basis of this growth it is reasonable to conclude that its impact is likely to be as significant as, or greater than, previous landmark divestment campaigns. Over the long term, divestment could have a financial impact on the valuation of fossil fuel assets[7] (both through stigmatization and through legislation encouraged by divestment), and the mere possibility of this is likely to spur changes in corporate behavior at the margin.

Divest Duke recognizes that our society currently relies on fossil fuels, and that this reliance cannot be undone instantly. However, there is a widely acknowledged need to reduce this reliance, which will only occur through social and political pressure to do so. Divestment by respected institutions provides such pressure by indicating that further investment in fossil fuels – investment which lasts decades – is ethically unacceptable (and potentially financially risky). At a societal level, shifts in investments away from fossil fuels and towards alternatives is required to reduce our current reliance on fossil fuels.

3. Divestment Involves Challenges, but These Challenges are Not Insurmountable

[3] Ansar, A., Caldecott, B., and Tilbury, J. (2014). Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets? Oxford University Smith School of Enterprise and Environment Working Paper.

[4] Teoh, S., Welch, I., and Wazzan, P. (1999). The effect of socially activist investment policies on the financial markets: evidence from the South African Boycott, Journal of Business, 72: 35–89.

[5] Ding, N, Parwada, J.T. and Shen, J. (2014). When does a stock boycott work? Evidence from a clinical study of the Sudan divestment campaign. University of New South Wales Working Paper.

[6] Hong, H. and Kacperczyk, M. (2009). The price of sin: The effects of social norms on markets, Journal of Financial Economics, 93(1): 15-36.

[7] *Supra* note 3, p. 50.

We next consider two challenges which serious divestment proposals must address: the administration of commingled funds and compliance with fiduciary responsibility. These challenges, particularly the former, will take time to resolve, but as argued by endowment investment advisor Cambridge Associates, "[they] are not insurmountable"[8].

3.1. Full divestment will require asking some investment managers to create divested portfolios, or moving funds to managers who are prepared to offer such portfolios.

Our discussion in this Section is based on assumptions about the configuration of the Duke Endowment[9]. The Endowment contains over $7 billion held in more than 4400 funds, together known as the long term pool (LTP)[10]. Tranches of the LTP are contracted for management by approximately 250 external investors, predominantly private equity firms, venture capital firms, and hedge funds.

We recognize the challenges posed by this configuration: large commingled holdings managed by hedge funds, few single managed accounts or direct holdings, and the need to maintain good investor relationships. To manage these we present a series of measured, separable, divestment actions tailored to each investment class. We also note that only 2-6 percent[11] of the endowment is likely to be held in fossil fuels, and that this exposure is likely to be concentrated in 15-30 percent of externally managed tranches[12]. The majority of the LTP will be unaffected by any of our proposals.

A. Directly held portfolios and single managed accounts (public equity and debt):

A.1. Duke University divests from direct holdings and single managed accounts. These classes of holdings are trivial in size, but are relatively simple to divest[13] and symbolically important.

A.2. The University publicly commits to abstaining from direct investments in fossil fuels in the future.

B. Directly held derivatives:

Duke University takes no action. We recognize that these investments are used for risk management and do not represent value investments.

C. Externally managed passive portfolios (public equity and debt) (if applicable):

Duke University requests that funds in passive portfolios with fossil fuel exposure are shifted to non-exposed passive portfolios at the conclusion of relevant management contracts (if applicable). The widespread existence of divested passive portfolios suggests that this is readily achievable over an approximately five year period.

D. Externally managed active portfolios (venture capital and private equity):

---

[8] Cambridge Associates (2014). Research Note: The Divestment Discussion. Available online at < http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2014/06/Fossil-Fuel-Divestment1.pdf >

[9] This understanding is based on numerous discussions with former university endowment managers (of similarly sized endowments to Duke's), investment professionals, and a DUMAC representative, in conjunction with publicly available data. Many details about the Duke Endowment are confidential and thus unavailable to Divest Duke.

[10] Other funds are also managed by DUMAC, but do not fall under the Board of Trustee's governance. Divest Duke does not seek changes to those pools' management.

[11] *Supra*, note 3, p. 11.

[12] *Supra*, note 9.

[13] In addition to not requiring negotiation with investment managers, direct holdings are already being evaluated by DUMAC on environmental, social and corporate governance (ESG) criteria.

Duke University takes no action. Firms benefiting from these classes of investments are not part of the Carbon Tracker 200. We also recognize the particular contractual difficulties in selling these classes of investments.

E. Externally managed active portfolios (public equity and debt):

E.1. We expect that these investments are held primarily with hedge funds, with whom maintaining positive relationships is important. We do not call for premature termination of existing contracts (if applicable[14]).

E.2. Duke University signals its intent to make future investments in fossil fuel divested portfolios. The University (via DUMAC) discusses this intent with both the relevant hedge funds and with partner shareholders of the relevant portfolios (if known).

E.3. If other shareholders (including self-invested hedge fund managers) wish to maintain fossil fuel exposure, DUMAC looks to alternative managers who do or will provide non-exposed portfolios. This could be undertaken with other investors looking to divest from fossil fuels. Given the rapid growth of the divestment movement[15] (which now includes large universities) we believe this will become increasingly feasible over the next 5 years.

3.2. Fiduciary duty does not present a legal barrier to prudent fossil fuel divestment or ethical investing in general.

Fiduciaries overseeing the endowment funds of private universities, operating as nonprofit corporations, have some latitude in allocating investments on behalf of a university. They owe their fiduciary duties to furthering the nonprofit objectives of their universities rather than specified beneficiaries or shareholders. Oversight is provided by Attorneys General or by affected parties that can establish a breach of a fiduciary duty, damage occurring, and proof that 'but for' the breach of fiduciary duty, the damage to the organization would have been prevented.

Fiduciary duties are accepted as encompassing two obligations; a duty of care and a duty of loyalty. The duty of care requires that directors and trustees carry out their obligations by ensuring that they take adequate steps to monitor the overall performance of the organization. The duty of loyalty obligates fiduciaries to exercise their duties in the best interests of the organization and to make investment and other decisions based solely on the organization's interests rather than their own[16].

We wish to make four points with regards to concerns over Duke University's fiduciary responsibility:

1. Legal research received by Divest Duke states that the duty of loyalty suggests directors "owe a duty to ensure that the assets are invested in ways that are congruent with the organization's articles of incorporation or governing charter". Given the University's broad mission statement[17], and its public commitment to sustainability, we believe that prudent fossil fuel divestment (as described in Sections 3.1 and 4) is consistent with the interests of the institution.

2. In exercising business decisions, directors enjoy the protection of the business judgment rule. This holds that if directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company, courts will not second guess

[14] We understand that many funds are held on an ongoing basis without specific termination dates.

[15] *Supra* note 3, p. 50.

[16] Gary, S.N. (2011). Is it prudent to be responsible? The legal rules for charities that engage in socially responsible investing and mission investing, NW. J. L. & Soc. Policy, 106.

[17] "Duke University seeks to engage the mind, elevate the spirit, and stimulate the best effort of all who are associated with the University; to contribute in diverse ways to the local community, the state, the nation and the world; and to attain and maintain a place of real leadership in all that we do." Available online at < http://www.trustees.duke.edu/governing/mission.php >

directors' decisions (even if they turn out to be harmful for the organization). The legal research we received informs us specifically that a decision to divest by a nonprofit organization would be unlikely to be overturned by a court.

3. A history of successful divestment and investor activism by Duke University (Apartheid in 1986, Darfur in 2005, conflict minerals in 2012) provides precedent, as does the fact that other fossil fuel divesting institutions have not been subject to legal challenge.

4. Finally, questions raised[18] over potential overpricing of assets with high carbon exposure means that it is not obvious that divestment is inconsistent with maximized risk-adjusted returns. Investors will increasingly need to consider the risks of exposure to fossil fuels. Arguments for divestment are being made on these grounds alone.

4. Partial Divestment is Worthwhile In and Of Itself

Divest Duke believes that full divestment (see Section 1) is a course of action consistent with the University's mission statement and sustainability goals, and is consistent with the magnitude of the social harms in question. We also believe that the challenges posed by commingled funds can be overcome given an adequate time horizon. Should ACIR and the Board of Trustees, after research and deliberation, disagree, we urge both bodies to consider partial divestment. Partial divestments could become components of an iterative divestment strategy, in which Duke University first acts modestly, and in subsequent years evaluates whether more assertive action has become justifiable. This would match the potentially iterative nature of the global divestment movement. We present options for partial divestment and discuss the complementary role that may be played by shareholder activism.

4.1. Partial divestment Option 1: Limit divestment to coal:

Undertake the divestment strategy proposed initially (see Section 1) but limit to the 100 publicly traded coal companies that own a majority of the world's coal reserves as identified by the Carbon Tracker Initiative[19].

Coal is responsible for 45 percent of energy-related CO_2 emissions[20]. It has the highest carbon intensity of any fossil fuel, with almost double the CO_2 emissions per unit of electricity of natural gas[21].

We note that the global coal industry appears to be in structural (rather than cyclical) decline, with new regulations and import tariffs reducing demand in the US, India and China, and competition from natural gas and renewables diminishing market share globally[22]. We suspect that many hedge funds have themselves already begun divesting from coal. Consequently, coal divestment from commingled funds is likely to be more easily implemented than full fossil fuel divestment and have negligible or no costs to investment performance.

In the instance that carbon capture and storage technology becomes viable and widely deployed in the future, Duke University may like to reconsider coal investments.

---

[18] See for instance HSBC (2012). Coal and Carbon. Stranded assets: Assessing the risk. Available online at < https://www.research.hsbc.com/midas/Res/RDV?p=pdf&key=dXwE9bC8qs&n=333473.PDF >

[19] *Supra* note 1. We consider this list to be a guide, rather than strictly prescriptive.

[20] Energy Information Agency (2012). Global carbon-dioxide emissions increase by 1.0 Gt in 2011 to record high. Press release available online at < http://www.iea.org/newsroomandevents/news/2012/may/name,27216,en.html >

[21] 2100 lb CO_2 equiv/MWh for coal versus 1100 lb CO_2 equiv/MWh for natural gas. Jaramillo, P., Griffin, W.M. and Matthews, H.S (2007). Comparative life-cycle air emissions of coal, domestic natural gas, LNG, and SNG for electricity generation. Environmental Science & Technology. 41(17): 6290-6.

[22] Carbon Tracker (2014). Recent financial trends in global coal mining. Available online at < http://www.carbontracker.org/wp-content/uploads/2014/09/Coal-Financial-Trends-ETA.pdf >

4.2. Partial divestment Option 2: Limit divestment to direct holdings, single managed accounts (and indirect passive holdings).

Divestment from the very small direct holdings (and single managed accounts holdings) is an administratively simple approach that can be implemented on a time frame of months, rather than years. This option would likely be feasible for the whole suite of fossil fuels, given that DUMAC has full control over how these investment classes are treated. (If applicable, indirect passive holdings may also be suitable for divestment under this option. The ready availability of divested passive portfolios suggests that doing so over time would be relatively straightforward.)

We believe that this option would have a smaller impact (on the strength of public pressure for climate change action) than full divestment. However, we recognize that such token divestment retains merit given that divestment's impact stems from symbolic value. Media coverage of previous institutions' divestment, for instance, has focused on general ethical principles rather than exactly what quantity of investments were divested[23].

4.3. Partial divestment Option 3: Complement partial divestment with shareholder advocacy.

Should it embark only on partial divestment, the University should complement its actions through engagement with those firms (which Duke is still invested in) which are amenable to change. For instance, we note that a number of shareholder resolutions have targeted methane leaks (a contributor to climate change) and firms' lobbying on climate policy. However, pass rates are low[24] and address relatively minor climate change issues (improved emissions reporting, for instance). Given the (not surprising) failure of shareholder resolutions which have addressed the core business of fossil fuel firms, we are not optimistic about the potential for more than marginal change through this approach.

5. **Divestment From Fossil Fuels Will Remain a Hot Topic**

Fossil fuel divestment is becoming a mainstream idea: Statements in support have been made by US President Barack Obama, UNFCCC's Executive Secretary Christiana Figueres, UN Secretary General Ban Ki-moon, World Bank President Jim Yong Kim, and The World Health Organization, among others.

A number of institutions – cities, pension funds, churches and universities – have begun divesting with positive results for the climate change conversation and their institution's reputation[25]. Similar action by a large, globally recognized university such as Duke would help galvanize the movement at a time when public opinion, and the resulting actions by governments, are at a crossroads. In 2015, governments at the United Nations Climate Change Conference in Paris will try to establish a binding agreement on carbon emissions, and public pressure is critical for ensuring a positive outcome. A divestment announcement by Duke University in the spring of 2015 would bring much needed focus and media attention at a critical moment. The US must take a leadership role in the Paris negotiations, and only attention and concern from the American public can ensure that such leadership occurs.

However, climate change will not recede as a public policy issue beyond 2015. Questions about the ethics of the use of and investment in fossil fuels, along with concerns about the risk of stranded assets, are unlikely to disappear, and calls for divestment will likely persist. In this context there are significant reputational benefits to Duke University moving proactively, rather than reactively to the issue. In divesting, Duke University would signal its commitment to environmental leadership in a way that will benefit the University's reputation, and the climate change agenda, far into the future.

---

[23] Stanford University's divestment (coal only, from direct and single managed accounts) and the subsequent media attention is an example of this.

[24] For example, 11 of 44 US shareholder resolutions on "climate change" in the oil and gas sector passed between 2011-14. Those that passed only tangentially addressed greenhouse gas emissions. See the CERES database at < http://www.ceres.org/investor-network/resolutions/shareholder-resolutions >

[25] *Supra* note 23.