The BP Oil Spill and ESG | June 2010

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The BP oil spill is already proving influential in environmental, social, industrial and political spheres. It will also be pivotal in institutional investment practice. There are two areas likely to be impacted: equity portfolio construction; and the concepts of ESG investing (Environmental, Social and Governance) and universal ownership.

There are estimated to be around 18 million UK individuals who hold shares in BP, either directly or more likely indirectly through their pension funds. The large number of holders is compounded by the big exposures involved – BP's value given the typical 'home bias' to UK listed shares was likely to have started out as around 6% of total equities. BP's performance post-Deepwater Horizon would have caused a net portfolio loss of about 2.5% to date. In contrast, the numbers of US individuals who hold BP shares is far higher than in the UK but their exposures are much lower – well under 1% in most cases reflecting BP's size in a global portfolio. In strategy terms, the UK investor has been badly served by an outdated idea of investing domestically first (and it is debatable how domestic BP is) and investing overseas second. Investing globally first is much more in keeping with global trends. The simple approach of using global equity portfolios gets around this concentration issue.

BP is a simple but powerful example of the risk of investment concentration. The principle of diversification remains a bed-rock of investment theory. While the global financial crisis gave us the understanding that diversification could become stressed when markets became stressed, it certainly has not changed the view that lots of smaller exposures are better than a few larger ones. A 6% position in a company with stock-specific issues stands out – why be that concentrated when there is so much diversification possible globally? Institutional investors might also consider the global capitalisation weighting of the energy sector of around 11%. Is that an appropriate allocation? The measured response should be from a macro view that sizes up longer term prospects and might reasonably conclude that fossil fuel companies have some bigger risks and uncertainties ahead, given the new political reality following the BP accident. The current average weighting may be appropriate, but the point is that it is surely sensible for institutional funds to test it. To date industry practice appears to have been more intent on managing relative risk (staying in line with average weights) rather than absolute risk (limiting concentration). And it has been more inclined to control asset allocation through countries when sectors can sometimes be much more of the picture.

There is another route that an institutional investor might consider. It is to think less about the weights suggested by current market valuations and more about weights reflecting future economic prospects. The question is how these might have changed given the BP influence. Enter the connection with ESG investing.

This leads to the tricky and growing issue of companies' externalities and their place in investment strategy. Externalities have until recently been kept in the arcane land of economists, but in an increasingly inter-connected world they now seem to be everywhere. We must understand them better and deal with their impact – both in society generally and in investment portfolios. Negative externalities are spill-over production effects that cause unwitting parties to incur costs for which no appropriate compensation is paid. Oil companies have arguably had a long history of producing externalities. Some of the particular externalities of the Gulf of Mexico accident – principally environmental and livelihood costs – are in this case being compensated through the creation of the special USD 20bn escrow fund that the Obama government and BP have established. But it should be remembered that this is not a cap on the costs or indeed designed to cover all costs. This internalising of costs is an uncertain and problematic process – spill-over effects are complex and contentious to calculate and there are always issues as to where compensation should end. The considerable volatility in BP's share price reflects these uncertainties.

The issues go much wider though, and affect the whole energy industry. If one takes the reasonable view that oil extraction is increasingly difficult, the possibility of future accidents becomes a bigger factor in the investment view of all oil companies. That calls for a view about the likely nature and associated externalities of any future accident and what compensations would be likely. In short, some calculations have to be crunched with potentially very large numbers attached to small probabilities in a highly uncertain environment. It is more than a possibility that oil companies are not presently valued by investors with their oil reserves and rights accurately reflecting the full costs of production.

This is worrying for the large institutional investors that hold BP and other oil companies in proportion to their economic size. Are they destined to see their holdings shrink in value as this issue progresses? The first response that institutional investors should make is to be more prepared to make some sense of the externalities jungle. This requires placing estimated values on these costs in anticipation that they will be internalised in the future. This is a practice that is already in evidence in the field of ESG investing in which the 'extra-financial factors' of environmental, social and governance influences are taken into account alongside mainstream financial metrics. Of course the estimation of particular externalities and pathways to internalising them remains highly problematic. But that makes successful incorporation of ESG in an investment process a differentiator in the future. Institutional investors will need to be skilful in their assessment of these hard-to-estimate values and will need expanded support for their decisions through new benchmarks and security-level models that assess ESG factors in detail. They will also need new honed skills in assessing investment opportunities in the renewable energy and clean energy fields that appear to emerge from this crisis with increased political support and funding.

As markets strive to integrate ESG factors, the question to consider is how efficiently the markets are assessing externalities and whether the global valuation of the oil sector had adapted to a new cost and externality structure post-Deepwater. There is little sign of this so far – other oil companies have not seen much valuation change relative to the rest of the market. In an integrated ESG investment world a bigger response might have been expected to materialise.

There is another way for large institutional investors to react rationally to this new challenge to their interests. This is to look at their ownership interests in companies (that they are effectively tied to over time) as opportunities to influence their boards in directions that optimise the sustainability of their long-term interests. The methods that institutional investors might use to achieve these goals may centre on engagement with company boards to produce changes that secure better long-term outcomes. The obvious question arises over why this would differ from, or indeed improve upon, the current corporate strategies that boards adopt today. The main area of difference could well be time horizon. Corporations may feel driven to satisfy the shorter term needs of most investor appetites, but there is a strategy of longer term optimisation of sustainable value that could be adopted. As an example, the long-term asset owner might encourage a different safety culture and try to head off at the pass the accidents that some companies appear to be risking because they perceive they must operate lean for short-term profitability reasons.

The idea of large investors doing more long-term good with their holdings under an enlightened sustainability banner while invoking solid granite finance principles produces quite a compelling prospect. There has been plenty of talk about this approach since Robert Monks used the term 'universal ownership' in 2001. In a nutshell, universal owners are the large institutional investors who recognise that through their portfolios they own, and will always own, a slice of the whole economy. They therefore adapt their actions to try to help the whole economy to a more prosperous and sustainable future. Universal ownership has been more talk than action so far. Institutional investors have had their own short-term bogies and struggled with their multi-decade responsibilities given their short-term pressures and career risk issues. But when it comes to the multi-decade issues of sustainable energy and resource depletion, the ESG investing approach and the principles of universal ownership are likely to leave a lasting mark. And it is the BP spill that may prove the defining moment in the journey.

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