2015 3rd Quarter Stock Market Commentary

NO FRACKING WAY

Litigation is the basic legal right that guarantees
every corporation its decade in court.
- David Porter

The Middle Ages were a tough time to catch a cold. Little was known about human anatomy, so medical treatments were based upon folk medicine and superstition. Not surprisingly, few people lived to see their fortieth birthday. At the time, it was thought that all illnesses derived from an imbalance of the four "humours", or bodily fluids - black bile, yellow bile, phlegm or blood. A common treatment to restore balance was bloodletting, which was accomplished in one of three ways. All the methods served the same purpose, to alleviate the excess blood to return the patient's humours into balance.

Not surprisingly, bloodletting was not a terrifically successful strategy, as many patients bled to death or developed serious infections. As a side note, blood letting was often done by the local barber, who also pulled teeth and performed many operations. The barbers would advertise their services by wrapping bandages around a pole placed at the door, giving rise to the red and white striped barber's pole.

Fortunately, modern science has evolved. Patients no longer need to subject themselves to treatments based upon superstition. But nevertheless they do. WebMD reports that up to 85% of people who develop a sore throat and sniffles request an antibiotic, despite the fact that it increases antibiotic resistance and does absolutely nothing to cure the cold. Somehow we seem to feel much better doing something rather than nothing, even if that something is not only not effective, but might have adverse consequences.

Many environmentalists would argue that the earth itself is sick. They point to the death of coral reefs around the world and the sharp increase in the deaths of moose (probably from the encroachment of parasites in habitats which were previously too cold to support them) as two of many possible "canaries in the coal mine." And while there might be many different causes for these population collapses other than climate change - such as excessive use of pesticides, or hormones used to fatten livestock, to name two possibilities - there is little doubt that human activity has likely increased global warming over the past century. Fully 97% of earth scientists agree with this position, and almost every scientific organization, including the American Association for the Advancement of Science, the U.S. National Academy of Science as well as the national academies of 80 different countries, the American Meteorological Society and the

American Medical Association, have published statements supporting this view. Assuming you agree with the consensus position (and we do), what is the best way to effect societal change to reduce the long-term threat?

One approach advocated by many, and the reason this is the theme of an investment-related essay, is to urge college and university endowments to divest their endowments of the stocks of companies engaged in fossil fuel production and distribution. The use of divestment as a tool to promote societal change dates back to the 1960s when it was first adopted by Stanford and Michigan State to protest South Africa's system of apartheid. This movement gained traction a decade later, but was not particularly effective until it was accompanied by broader economic sanctions. According to a 1999 study by Ivo Welch and C. Paul Wazzan South African companies targeted by the divestment campaign experienced no discernible financial pressure, as shares were simply reallocated from "socially responsible" to more indifferent investors. When endowments were pressured to sell off the stock of companies active in South Africa, other buyers simply stepped in to pick up the pieces

More recently a variety of organizations have tried to use divestment to pressure Israel to give back the Palestinian territories seized after the 1967 Arab-Israeli Six Day War.

The current campaign to use divestiture of fossil fuel stocks to impact the rate of climate change dates back to 2012. Students groups pushing for such measures are active on more than 300 campuses across the country, including Harvard, Yale, Ohio State, Stanford, Swarthmore, Cornell, and the University of Colorado, although only a few colleges and universities have actually implemented the strategy, which calls for eliminating investments in the 200 largest energy companies, including Exxon Mobil, Shell and Chevron, to name just a few. In addition, a number of local governments, including Seattle, San Francisco, Boulder, and Madison, Wisconsin, have pledged to dump fossil fuels from their pension fund investments because of the industry's responsibility for the climate crisis.

Unfortunately for advocates, divestiture is a strategy not likely to be widely adopted. Up until now, divestments have been by charitable foundations, educational institutions and government entities. Individuals own nearly 40% of all publicly traded equities, but the largest category of institutional owners is retirement plans. Here the law is very clear. The sole duty of pension plan fiduciaries is to act in the interest of retirement plan participants. They are required to focus on their responsibilities to current and future retirees, not their ideals for a better world, or they can be held personally liable for foregone retirement income.

And the data indicates that an energy free portfolio does not perform as well as one which includes them. Professor Daniel R. Fischel, former Dean of the University of Chicago Law School, undertook a study in which he constructed two optimal investment portfolios, one with and one without, energy stocks. He then analyzed the investment performance of both over the fifty year period 1964-2014. The energy free portfolio trailed the portfolio which included energy by 0.7% per year, a fairly substantial difference. A $1 million portfolio which earns 7% per year will grow to $29,457,025 in 50 years. The same portfolio will reach $40,811,745 at 7.7% per year, a difference of more than $11.3 million!

Moreover, the energy free portfolio was less diversified (and hence riskier). Prof. Fischel computed the correlation coefficient for each of the major stock market sectors (energy, technology, healthcare, utilities, etc.) over these 50 years. For those readers with no statistics background, a correlation coefficient measures the degree to which two sets of data depend upon each other. It ranges from -1 to +1. A coefficient of 1 means that the two data series are perfectly correlated, while a coefficient of 0 means there is no dependency of one upon the other. The energy sector was the least correlated with the others. Thus, by excluding it from the portfolio, the holdings became more correlated and hence more vulnerable to macroeconomic shocks.

Finally, an energy free portfolio will incur increased compliance costs. Each fund needs to specify the criteria for a stock to be included or excluded from the fund. As companies evolve over time, holdings need to be monitored to insure that they continue to satisfy the established restrictions. For example, a company that manufactures steel pipe used in commercial construction may buy another which makes drilling pipe. It may then need to be excluded from inclusion in an energy free portfolio because of its change in strategy.

Increased compliance costs, reduced diversification and lower rates of return beg the question of whether a policy of divestment is likely to be effective. The sad truth is that management of a public company which does not need additional capital does not really care who owns their stock. Forcing one group of shareholders to sell their shares to others will have no effect on corporate behavior. In fact, most corporate managements would probably prefer that they not have to respond to shareholders who are lobbying for a radical change in strategy. If somehow divestment advocates were successful in getting nearly all institutional shareholders to sell their shares simultaneously, the negative momentum in energy shares would force them down far below the intrinsic value of their assets, attracting financially oriented buyers. It is not a coincidence that the stocks of firearms makers, like Smith & Wesson, and cigarette manufacturers, like Altria, which were the targets of previous divestment campaigns, are among the best stock market performers in recent years.

There are steps, however, that activists can take which might make a big difference. One is to lobby Congress and the administration to permit the exportation of natural gas to other countries to encourage them to replace their coal powered plants. The four largest coal fired power plant operators are China, the United States, India and Japan. In the past two years consumption in the U.S. for this purpose dropped more than 15%, while Japan's usage declined modestly. China's usage increased more than 15% and India's increased more than 20%. A single coal powered power plant generates 2,249 lbs of carbon dioxide per megawatt hour, compared to only 1,135 lbs for a natural gas fired plant. Getting Congress to allow the shipment of our abundant natural gas could go a long way toward reducing carbon dioxide emissions, the most abundant of the greenhouse gases.

Second, urge tax policies that encourage both businesses and individuals to pursue energy efficiency. Individuals, for instance, can better insulate homes, use programmable thermostats to reduce heating and air conditioning use when houses are unoccupied, install more efficient appliances and drive cars chosen for lower gasoline consumption. Businesses can redesign manufacturing processes to utilize cogeneration techniques making use of waste heat, and replace older motors with newer, more efficient ones.

Finally, activists can donate to organizations which promote better education in the developing world, since better education historically has led to declining birth rates, and rapid global population growth creates demand for energy from all sources.

As we have seen above, people urging divestment are implicitly willing to pay a financial price for their principles in the form of lower portfolio returns and increased compliance costs. But those same dollars could instead be allocated to promoting policies which will have a direct impact on the problem. Lobbying for divestment is like taking an antibiotic for a cold. It feels good to be proactive in addressing the problem, but it is not a particularly effective treatment.