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ESG and the War in Ukraine: Part 1

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Reading the financial press these days is something of a good news/bad news story. The good news: we're not collectively focused on COVID-19 anymore! The bad news: war in Ukraine, with a non-zero probability of sparking major conflict elsewhere, has taken its place among the headlines. As major events tend to do, Russia's invasion of Ukraine has offered multiple lessons on the complexities of global economics and politics (this was, unfortunately, not how I hoped to get a crash course on the intricacies of the SWIFT messaging network or the importance of Ukraine in the global wheat market).

For those of us in the ESG world, too, this conflict has sparked numerous debates about whether investing in certain countries or industries is consistent with an ESG investing philosophy. Some of these debates, however, hinge on a misguided notion that ESG is monolithic with clear definitions. The biggest misconception—and one that strikes right at the heart of the entire edifice of ESG investing—is that some companies or industries are "ESG" while others are not. We have long cautioned friends and colleagues against the use of the phrase "ESG-friendly," which implies that there is a bright line neatly dividing the world's companies into two camps. As with any intellectual exercise, definitions matter enormously in the world of ESG. As a recent Bloomberg article put it, "The rapid pace of growth [of the ESG industry] has led to a more elastic definition of ESG, with an ever greater universe of financial products and strategies using the label." We have seen some of these definitions being stretched to breaking point. As we discuss in Part 3 of this series, various attempts to label defense companies as "socially desirable" demonstrate the shaky foundations of some of these concepts.

Incidentally—and we promise to elaborate later—this is not because defense companies do not serve a social purpose. Rather, it is because so many companies serve purposes that could be deemed "socially desirable." A sophisticated ESG analysis of a company must grapple with a company's business model, but it must also be a deep exploration of why the company and its products exist. I am often reminded of the theory of functionalism in sociology. In functionalist theory, different parts of society are made up of social institutions, each designed or evolved to serve different needs. By one definition, "According to functionalism, an institution only exists because it serves a vital role in the functioning of society. If it no longer serves a role, an institution will die away. When new needs evolve or emerge, new institutions will be created to meet them."

The sociologist Robert K. Merton divided these functions into two types: manifest functions, which are intentional and obvious, and latent functions, which are unintentional and not obvious. As an example, the manifest function of attending a football match is to support one's team, but the latent function may be to engage in camaraderie and fulfil the desire for belonging to a group. Merton believed that manifest functions were easily apparent but that latent functions were far more subtle, and that uncovering them often required the sociological approach.

At this point, you may well be wondering what this has to do with ESG. Simply put, when we use labels such as "ESG-friendly" or "socially desirable" to characterize some group of companies, we are neglecting the manifest and latent functions of many other firms. Given the extraordinary complexity of the global economy, even companies which seem mundane contribute mightily to the smooth functioning of the overall system. For example, "watching paint dry" might be a recipe for extreme boredom, but a significant portion of physical infrastructure relies on the paints & coatings industry for protection from corrosion and damage. This surely is a valuable social function – but labelling this activity "socially desirable" thereby renders the term largely useless.

Furthermore, even industries which have obvious ethical complexity—and we'll speak further about several examples, such as energy, defense and Big Tech—clearly have important roles in politics, society and the economy. While we will not cover the traditional “sin stocks” such as alcohol, tobacco and gambling in this series of posts, we hope to discuss them at a later stage. Understanding the complex social customs around potentially addictive substances is essential to unpacking the latent function of these companies. For now, we will summarize our view that, as ESG analysts, we need to go beyond the headlines to understand the latent function of these companies to better evaluate if we feel comfortable owning them.

This should not, by the way, be taken as our advocating for a laissez-faire approach to any of these industries. It goes without saying that each of the industries mentioned above has controversial points (in some cases, generating negative externalities) and requires government regulation. One of the major critiques of functionalism in sociology is that it perpetuates the status quo and does not sufficiently explain how social change occurs or when it is desirable. In fact, this and other critiques caused functionalism to fall out of favor compared to other theories which demonstrated how change occurred. We certainly do not see companies’ positions as static or necessarily desirable: in fact, as active shareholders, we believe we should communicate our views to companies on how they should act for the benefit of shareholders and society at large, acknowledging that trade-offs are inevitable.

Finally, to give due credit to classification systems such as the EU Social Taxonomy, we do not believe these are designed as the ultimate arbiters of “social usefulness.” Rather, they are meant to delineate which business activities align with a narrowly prescribed set of social goals. The danger, however, is that some investors have begun to confuse the EU’s taxonomy with a broader definition of social value.

This perspective has major implications for our views on the role of financial divestment, a thorny subject to which we turn in Part 2 of this series.