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ESG and the War in Ukraine: Part 3

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In Parts 1 and 2 of this series, we laid out our critique of the imprecise "ESG-friendly" label. We also explained our views on the limitations of divestment. From our vantage point, both factors have combined to create a great deal of confusion with Russia's invasion of Ukraine. We now turn to specific sectors where we see ESG investors and analysts wrestling with different forces.

Energy

We have been writing about the energy sector from an ESG standpoint since 2019. One of our early pieces asked simply, "Can a Responsible Investor Own Fossil Fuel Equities?" Our conclusion was that fossil fuel producers presented a challenge for investors, but that investors should not shy away from the sector if they were armed with the right ESG framework. A year on from that piece, in October 2020, investors were extraordinarily pessimistic about the prospects for fossil fuels given a more favorable regulatory outlook for low-carbon fuels amid the recovery from COVID-19. And yet, an already tight market for hydrocarbons has kicked into overdrive with the Ukraine/Russia conflict. This is forcing several ESG-oriented investors to rethink their low allocations to the traditional Energy sector, particularly as many ESG strategies became implicit bets on being overweight Tech and underweight Energy.

Our view as an ESG team has been consistent on this front: we should not divest from the sector, given the importance of fossil fuels for the current energy mix and the likely importance of these energy sources for the foreseeable future. Nonetheless, we work closely with our analysts to assess long-dated investment plans as climate transition risk could create stranded assets. We do not see this as being incongruent with investing in short-cycle assets in a high price environment, which merely strikes us as appropriate capital allocation. Ultimately, however, we prefer companies who can thrive on a longer-term basis in line with a shrinking global carbon budget.

It is far too early to tell how the Ukrainian conflict will affect the energy transition, but it certainly appears to be strengthening Europe's resolve to assure their independence from Russian supply over the long term. We suspect that energy security concerns will take precedence over climate change for the short term but that the push for low-carbon energy sources actually dovetails well with the push for energy security, if not outright independence.

Defense

Perhaps the sharpest volte-face has occurred in the defense sector, where some investors have removed their blanket exclusion on defense companies. Clearly, it is top of mind that having a strong military deters potential aggressors. The defense industry appears to have won some concessions from the European Commission, which removed an earlier reference to defense companies as socially harmful from its Social Taxonomy. However, some commentators are going even further, arguing that all of ESG rests on the freedom and rule of law bolstered by defense companies, and that they should therefore be considered more positively in the Social Taxonomy. The notion that defense companies should be included in this category speaks to the highly subjective definitions involved.

A slightly more nuanced view seeks only to exclude companies with exposure to "controversial weapons", usually above a certain threshold of revenue. The definition of "controversial weapons", however, is far from settled. Different countries and institutions focus on some combination of chemical and biological weapons, cluster munitions, antipersonnel landmines, nuclear weapons, incendiary weapons and blinding lasers.

While we do not believe in divestment from the defense sector, we do not want to give the industry a free pass either. We note that several large defense companies have been embroiled in corruption scandals over the years given their dependence on government spending. The newfound enthusiasm for defense companies should not prevent ESG analysts from scrutinizing the defense sector's role in government corruption.

Technology

We will only discuss the tech sector briefly, as we hope to cover it in future blog posts. Nonetheless, it will not come as a surprise to readers that governments around the world have been eyeing the tech sector warily, and increasingly flexing their regulatory muscles. In the U.S., for example, it is expected that the Federal Trade Commission under Lina Khan will prove significantly less friendly to Big Tech. We do not disagree with this stance; these are large companies with an extraordinary amount of power, and appropriate government regulation is necessary to ensure these companies are acting in ways that benefit society. This could refer to ensuring competitive corporate behavior, protecting customer data or designing social media to better reflect accurate news. However, the war in Ukraine has been a reminder that the U.S. tech sector is, broadly speaking, an ally against foreign aggression. It is well-known that Russia has been engaging in cyberwarfare for years, with Ukraine being a major target. Since 2014, Russia has been accused of a range of cyberattacks on Ukrainian government and infrastructure entities. Russian groups such as the Internet Research Agency have also been implicated for their attempts to influence public opinion through social media. And in a world where digital and physical infrastructure are intertwined, we also saw a ransomware cyberattack on the Houston-based Colonial Pipeline system in 2021. U.S. utility companies work closely with the North American Electric Reliability Corporation (NERC) to bolster their cybersecurity, but it would be naïve to assume that the industry is immune to foreign aggressors determined to wreak havoc with the country's basic infrastructure. Clearly, this is an increasingly ferocious battleground. Some ESG-oriented investors may have to temper their antipathy to Big Tech in these times. Similarly, tech employees who exhorted senior management to desist from contracts linked to the U.S. government may be rethinking their positions.

Conclusion

As ESG analysts, our role is to articulate a clear framework that is robust to different scenarios, and which will allow us to take a step back from the deafening chorus of voices commenting on headlines. The crisis in Ukraine has revealed the need for more precise definitions and clearer thinking about the social function of companies in several sectors. We are committed to pursuing a rigorous, nuanced approach in our ESG analysis. A failure to do so would leave us at the mercy of swirling headlines and damage our goal of delivering long-term investment performance for our clients.