

# ESG Now Podcast

## “Can Bombs and Bullets Be Sustainable?”

Transcript, 4 April, 2025

Mike Disabato (00:00):

What's up everyone? And welcome to the weekly edition of ESG now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Deto, and this week we talk about whether or not the defense industry has a sustainability problem. Thanks as always for joining us. Stay tuned. An historic event occurred in late March in Germany. The exiting government, along with its houses of Parliament, passed a massive spending bill that was near a trillion euros. Now it's historic because apparently Germany doesn't take on any debt, but it was also because they told their defense industry that they could take basically as much money of that spending bill as they could spend. And if the defense industry in Germany does that, if it gets near that trillion euro ceiling, and then it's going to approach what the US currently spends on its military, which would be music to Germany's fellow EU members' ears.

(01:06):

Because unless you've been really enjoying your life and not engaging with geopolitical struggles, you might have heard that Europe is in the process of armament, a struggle that has not been seen since the terrible old days of global war on its continent. And the reasons for that is because, well, Russia invaded Ukraine, but also because the US who has built itself into the hard drive of many EU member states, militaries is starting to seem a bit less reliable. So an EU investor base that has sometimes looked at certain weapons as products to exclude from their investments are starting to confront the narrative that this ment is both necessary strategically and morally imperative. And that groundswell of positive opinion on defense has meant that there's been talk that sustainability and defense need to become better friends. The UK's ruling Labor Party wrote an open letter urging financial institutions to rethink ESG mechanisms that often wrongly excluded all defense investments as unethical.

(02:07):

France's financial market regulator wants to ensure that sustainable financial regulations do not create undue obstacles to defense spending. And the now in charge, Christian Democrats in Germany have also promised to remove ESG related obstacles to their defense investing. So I work for a sustainable finance company and I am the aerospace in defense research lead for that company. So it was an interesting narrative for me to see and I was curious about the accuracy of it. Yes, there has traditionally been a heavy dose of ethics or values attached to defense sector investments because their products obviously devastate the environment and society and it's a big problem. But setting aside sustainability, the defense sector has traditionally had a unique and challenging business model. There's long investment cycles, there's high uncertainty for clients and for producers. There's complex contracts that can take a while to be made good on.

(03:02):

The list goes on. And of course, the largest military contractors out there have always been well-funded and they have little trouble raising capital. But those problems that plagued the wider industry weren't caused by sustainable finance efforts. They were caused by the structure of the industry itself or so I thought. So to get to the bottom of this, I wanted to use this episode to examine a few hot button

questions, whether ESG ratings limit investment in defense companies. What investors usually do when they're either looking to exclude or include certain defendants companies and if there are agreed definitions of what constitutes weapons products that are considered controversial. So to do that, I have to kind of explore these questions in two different parts. One shorter part is going to be led by myself as the aerospace and defense sector lead for ESG ratings. So you're going to hear a lot from me for just a second.

[\(03:54\)](#):

And the other more detailed part is going to be led by my colleague Olga Anova, who helps run our exclusion research, also called our screening research. So let's dust off my part, shall we? For our ratings for aerospace and defense companies, we look at how they develop clean tech, which is an important aspect for both RD spend in the industry, but also extremely important for the aviation sector that is represented in the aerospace and defense GIS sector, which is where we group all the aerospace and defense companies. Now, regardless of your thoughts on cutting emissions, thus fuel means lower cost for civil aviation and longer mission times for military aviation on a single tank. It's a want by everyone that relies on the development of new planes and new engines and the like. We also look at aerospace and defense companies, how they train, retain and attract their employees, the effectiveness and quality management systems of the production processes.

[\(04:48\)](#):

You don't want planes falling out of the sky, of course, and we look at their leadership teams. Now even more importantly, aerospace and defense companies are rated on an industry relative scale within the industry. You have leaders on managing material ESG risks and laggards on managing those risks and everything in between because they're up against each other on their rating. Boeing is looked at in comparison to Airbus. Airbus in comparison to Lockheed Martin, Lockheed Martin in comparison to R Metall. You get the picture. And so you have leaders in the ESG space that also make missiles that kill people in our natural world or defend people and our natural world, depending on where you're standing, and you have laggards in the ESG space that also make those same missiles just with less in our mind. Commercial effectiveness when it comes to ESG material risks, the weaponry of the company does not impact what a rating does.

[\(05:39\)](#):

It provides an opinion on a company's management of those financially relevant ESG risks and opportunities. And it's the reality that the destructive force of a missile does not impact the financial wellbeing of the company that makes it, in fact, it often enhances it. What instead does impact a defense company's bottom line in our opinion is if it doesn't have mechanisms in place to manage or retain its workforce or it has a terrible time keeping its quality processes in place, or it has an executive team that is for example, too corrupt to even apply to government contracts. It's just not the weapons. So that's one hot button issue down ESG ratings and weapons. They really don't mess with each other like that. What about the other questions for that, I need to shift my focus to Olga because we need to first get into what screens even are to understand why some investors might use them to exclude certain weapons from their portfolios.

Olga Emelianova [\(06:35\)](#):

So screening is a very broad term and I think generally that describes the use case from the investor perspective. And of course you can screen for the purpose of including certain entities based on characteristics, things about sustainable impact metrics, something with a positive environmental or social impact, or it could be used for the purpose of excluding certain entities and the criteria could vary quite substantially. You can use ESG ratings for example, for excluding the worst rated companies. What I guess we are talking here specifically is the exclusion tied to the type of business activities that the company may be involved. And it could be quite a wide range of subjects. It could be some of the

traditional, what is called sin stocks, alcohol, gambling, tobacco, and of course, as we discussed, it could be related to the product such as weapons.

Mike Disabato ([07:40](#)):

Those weapons screens fall into a variety of different categories that span a weapons value chain from the direct manufacturing of the weapon itself to the manufacturing of the distribution platforms for that weapon like a launcher or a fighter jet, to the components of all those deadly and defensive pieces. And this is where some of the exclusions for some funds and indexes and sovereign pensions start to fold in because there are two important categories of military weapons screens. One is the conventional category, which include things like tanks or torpedoes or targeting mechanisms on weapons. Those usually don't get excluded in most portfolios. What does often get excluded is an amorphous term called controversial weapons, a term that has a lot of different opinions as to what should be included in it.

Olga Emelianova ([08:26](#)):

One of the most common approaches is to look into the types of the weapons that are characterized as mass destruction, non-discrimination, and therefore subject to international conventions prohibiting those weapons.

Mike Disabato ([08:43](#)):

Those conventions include the also convention on cluster munitions or the auto treaty on the prohibition of the use stockpiling production and transfer of anti personal minds and on their destruction or the convention on the OR restriction on the use of certain conventional weapons which may be deemed to be excessively injurious or to have indiscriminate effects protocol for on blinding laser weapons or the convention on the prohibition of the development production stockpiling and use of chemical weapons and their destruction. There really are a lot of conventions out there on weapons, and I haven't even named all of them,

Olga Emelianova ([09:17](#)):

And that's been usually the starting point. But there is also an additional factor that we realize that there is also additional sensitivities in the market to some of the types of the weapons that might not be covered by those conventions. For example, the definition of the controversial weapons that MSCI index team puts forward that includes depleted uranium components, which is not prohibited, but we know that depleted uranium has some qualities that make it much more extreme in terms of the CAU CAUS and the impact. So that is also included in broader market definition of controversial weapons.

Mike Disabato ([10:00](#)):

Depleted uranium weapons are what are called armor piercing munitions, and they contain depleted uranium, which is a byproduct of nuclear fuel enrichment. And they're used because they're really high density and they can penetrate armor on a tank, for example. So when you hear armor piercing, you're actually hearing depleted uranium. If it was a depleted uranium, it would be tungsten, which is useful, but it makes a blunter shell apparently and it can't really get through a tank. But depleted uranium is still about 60% radioactive compared to its non depleted cousin. So they can have some serious impacts on the health of individuals like soldiers and on the environment more impacts than just what a massive tank shell can do to a tree or a person if they're hit directly. So such as some member states in the EU have worked to try to ban their use, but other states in the EU are saying, no, we don't want to ban their use. We think these are important weapons. So depending on what sides are on there, you're going to have a very different definition of what is a controversial weapon, and that's not where the differences end.

Olga Emelianova ([11:03](#)):

On the other hand, there are also some of the evolving regulations that are trying to define what is controversial weapons. So think about European sustainable finance disclosure regulation where one of the principle adverse indicators actually describes controversial weapons, and in fact it's actually quite narrowly defined, both in terms of the types of the weapons and then also the value chain because you can consider producers, producers of components, producers of delivery systems, servicing companies. So SFDR has a somewhat narrower scoping, and that's one way to approach that. Well right now with the Omnibus and some uncertainties around some of the definitions, there's another approach to defining controversial weapons, which is more extensive and linking a lot of the international conventions. So as you can see, there is certainly quite a lot of disagreement in terms of what controversial means.

Mike Disabato ([12:06](#)):

Now, what those differences can do, for example, is they can make investors over correct and exclude more companies than are necessary from their investments just to make sure they don't run afoul of regulations. Now, I don't have any evidence that this is actually occurring, but that does happen when there is a lack of streamlined definition for a similar term within a regulators toolkit. But let's say for sake of example that our definition M-S-C-I-E-S-G research is definition of controversial weapons is the one that the market makes a rule. If you run our broadest exclusion screen for controversial weapons that casts the widest net, you see that really only 15 companies out of 85 in our coverage are going to get flagged. And that list does not include some of the big hitters. It includes some of them, but not all of them, and none of the included companies are European domiciled.

([12:55](#)):

Now, there are some Korean defense companies that are on the list, which Europe and NATO broadly have been pretty reliant on lately for ammunition especially. But none of the big EU, UK domestic defense names like BAE or Leonardo or the likes are flagged by us for having any tie to the production of a whole weapon system or delivery platform or the components of a controversial weapon as we define it. Now, granted, just to put this into context, just three of the 15 largest defense manufacturers are actually domiciled in Europe, but that again, seems to be a symptom of the industry itself and the EU's long-term position on armament rather than a public company's tie to controversial weapons and how sustainable investing sees that. So I asked Olga where she thought this narrative might come from, and she more so noted it seemed like just a broad regional point rather than something which was actively hindering defense spending.

Olga Emelianova ([13:52](#)):

It's not uncommon that a lot of European labels and regulations that address controversial weapons in some way, it's quite common to see that there are also a lot of very specific designated green labels in Europe that look into the aspect of controversial weapons or weapons in general. So it's not uncommon to see these types of approaches. I think it's becoming a little bit more challenging right now in the context of the situation in Europe and what's going on. So I think there is obviously quite a lot of emphasis and attention to supporting defense, increasing defense spendings. So a lot of those regulations and the requirements, they kind of back on the radar and becomes a big question for the investors because it's sort of a dilemma how we can apply those restrictions, but then also not misaligned with the national policies and national agenda to support defense sector.

Mike Disabato ([14:54](#)):

The good thing is if those national policies really want to focus on the development of local defense manufacturing, then the governments that are worried about the impact of sustainability on the

defense sector are probably in luck because usually they're focused on controversial weapons. And as I said, none of the companies flag for those in our screens are domiciled in the EU or the UK. Now, of course, that might change if the EU starts to ask its defense companies to manufacture, let's say cluster bombs, and then those regulations get triggered. Now, that's another story, but as of right now, it doesn't seem like sustainable investing or values-based exclusions for controversial weapons is a big problem for EU defense companies. There's one caveat to that, which I didn't touch on. There is an EU requirement that sustainable fund investments should do no significant harm to the EU's environmental and social objectives, but that does not preclude the investment in arms.

(15:49):

It just has to do with the EU taxonomy and not a topic that the EU is ready to solidify at the moment or what we can go into with the time remaining in this podcast. So for now, it seems the idea that defense has a sustainable investment problem seems to be inaccurate, and that's it for the week. I want to thank Olga for talking to me about the news with the sustainability twist, and I wanted to thank you so much for listening. Of course, if you like what you heard, don't forget to rate and review us that allows people to see our podcast more and subscribe if you want to hear ESG now every week. Thanks again and talk to you soon.

Speaker 3 (16:38):

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