TRANSCRIPT

War and ESG

Featuring:

Bentley Kaplan, *ESG Researcher, MSCI*

Mike Disabato:

What's up everyone? And welcome to the weekly addition 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 Disabato. And this week we have two stories for you. For the first, I discuss whether weapons and defense companies can be considered social impact companies as they defend invaders and bad actors from taking over a country. And then in the second story, we look at a Chinese company that left Russia before the invasion and then decided to come back after the invasion. Thanks as always for joining us, stay tuned.

A moral conundrum has been put to the ESG world during the invasion of Ukraine by Vladimir Putin. The conundrum goes like this: can the defense industry make a positive contribution to social sustainability by defending people? And so should it be considered a social impact industry? Some of the defense industry certainly thinks so. BDSV, a German defense industry lobby group, told Bloomberg that they were appealing to the EU for defense stocks to be considered socially sustainable in the EU's upcoming social taxonomy that is currently under development. Now we are moral arbiters here at MSCI ESG Research. And in our view, ESC is not a label of morality, it's a market signal that can be tailored for a number of uses, like risk avoidance or positive impact or financial materiality, that sort of stuff, not morality. But the question of whether defense is a social impact or not was a fascinating enough one for me to want to comment on it.

But I just want to be clear again on the onset. This isn't for us to really judge or to recommend one way or the other. Our job is to provide the tools and information to help investors make these calls for themselves by making as much reliable data accessible as we possibly can. So let's first dive into the data of what weapons and defense companies actually are. So for companies, we look at their ties to four types of weapons groups. There's civilian firearms, nuclear weapons, controversial weapons, and conventional weapons. Civilian firearms and nuclear weapons are pretty obvious, so I'm not going to dive into that category. But what about controversial weapons? Controversial weapons sounds like a moralistic moniker, doesn't it? But it's actually not a name we created. Controversial weapons are a term of art used in international treaties for those weapons that are so destructive, so indiscriminate, and so often used on civilian targets, that they have been banned by a number of UN treaties for use in modern warfare.

Think of the Geneva Protocol of 1925, the Biological Weapons Convention, the Chemical Weapons Convention, and the Convention of Cluster Munitions, to name a few, that banned the use of, among other things, chemical weapons and cluster bombs. So that leaves conventional weapons. Conventional weapons are more or less the main crux of where the social impact argument is being levied. Because in theory, these sort of weapons are soldier-on-soldier weapons, and so are used for countries to defend themselves as well as to go on the offense. And we look at company ties to a number of conventional weapons, which would be exhausting for me to list all of them. But just kind of think of those deadly machines that are so flippantly lauded in action movies, fighter jets, missiles, ammunition, grenades, those sorts of deadly tools. But also there's, in conventional weapons, training and simulation system or maintenance systems. These are included in that category.

There are around 156 companies in our coverage that have ties to conventional weapons. So 156. That's out of 9,000, a bit more than 9,000 that are in our coverage. But let's look at how many of those companies are actually in funds, or specifically in funds that have ESG in their name. Funds are the way most investors get exposure to companies. It's a diversified portfolio of companies that are run by a portfolio manager. So when you invest in a fund, you are investing in a portfolio manager's idea if it's a thematic fund. Or maybe you want to follow a broad market index if it's an index fund. So when you pick an ESG fund, you assume the manager is considering environmental, social, and governance risk factors and opportunities that are then used to create a value aligned fund, or a fund that has positive impact, or a fund that avoids the worst problems of climate change. Stuff like that.

So how many of these managers that have ESG funds currently view weapons and defense companies as fitting the social stratum of their investment strategy? Well, I looked at that. So right now in our coverage there are 28 investment funds that have ESG in their name and have more than 5% exposure by market cap to conventional weapons. As a side note, using that same 5% or greater exposure screen, there are actually three funds that have ESG in their name and have exposure to controversial weapons, which is pretty surprising. I looked at their holdings, and they have exposure to companies like Mindtree, Larson and Toubro, and L&T Technology Services that each have ties to cluster munitions manufacturing. For example, according to our data, Larson manufactures what's called the Pinaka multi barrel rocket launcher, a delivery platform that's capable of launching rockets of various types, including rockets equipped with cluster munition warheads. So that's an interesting thing to see in an ESG related fund.

And that 28 conventional weapon exposure funds and three controversial weapons exposure funds is not nothing. And what would be interesting is to check this data again in a couple months to see if the invasion of Ukraine by Putin increased the number of funds with conventional or controversial weapons exposure. Because some investors are agreeing that that needs to change. Some fund managers, like Sweden's SEB Bank, has decided to reverse earlier bans on the investment in the defense sector stocks due to events in Ukraine. And analysts at financial firms like Citibank have begun to argue that the importance of defending the values of liberal democracies is so important that weapons makers should be included in funds that carry an ESG label. Which, fine. If they believe leave that to be an appropriate use of their capital and investors are aware of what's going on, then sure.

Let's say you are an investor that cares about ESG, but also wants to invest in defense and weapons manufacturers. What ESG risk factors for those companies should be on the mind? Well, one ESG factor I would focus on, there are many ESG factors to look at for defense and weapons companies, but one major factor I'd be worried about, and what I wanted to highlight here for you all, is whether or not a company that is making weapons has had any bribery or corruption controversies associated with it, and whether they have a policy that covers bribery and corruption. Not only because these companies have access to some seriously deadly materials, but also because they are involved with government contracts that can create issues of bribery and corruption. US president Biden recently pledged an additional 800 million US dollars in military aid for Ukraine. EU states are pledging in the hundreds of millions of euros also to deal with this invasion by Putin to Ukraine. And some, like Germany, have even increased domestic spending in response to, as their PM calls it, Putin's war.

That means a lot of money is coming into these companies from governments, and you want to ensure that they don't have a history of taking bribes or engaging in corruption, and that they have a formal policy that covers bribery and corruption so people aren't at risk of doing that. So of those 156 companies with ties to conventional weapons systems, six have faced significant recent allegations of bribery or corruption. One of those companies, Lockheed Martin, has over 90% of its revenue tied to conventional weapons. The rest of them have under 30%. So going back to the broader 156 companies. More than half of those companies do have detailed formal policies on bribery and anti-corruption. The others though just make general statements that say, "We're just going to avoid that stuff," which isn't great for a company that has ties to such serious instruments as we weapons.

So here's where we get back to the original question that piqued my interest. And I deliberately did not give an answer here because I don't think it's actually one for us to answer, if you want to know the truth. If you are putting your money into the markets, it's good to know where that money is going and how it's being used. If it's being used to create tools that are used to kill other human beings and you cannot stomach that, then you should ensure that companies properly disclose this information, you avoid those companies at all cost using things like screens or ensuring that the portfolio manager's strategy explicitly says they avoid weapons manufacturers. If you take the view, as some other financial market professionals do, that are saying defense and weapons systems are necessary to keep order and bad actors in place and democracies around the world, then, okay, that's fine too.

The ambiguity of economic existence is that some companies have both positive and negative qualities to them. I looked at the aerospace and defense industry. This is where a lot of the weapons and defense companies operate. And I saw that around 10% of those companies are involved in some sort of sustainable social or environmental impact, like the development of clean technology and equitable transport. And they're also making weapons. It is an example of how ESG is not a barometer of right or wrong, it's a tool to better help investors make decisions on where they put their money. And that decision is often fraught with contradiction and ambiguity.

Last week, we focused on western companies' decisions to either stay or leave Russia as Vladimir Putin continues to bombard Ukraine. But this is a decision that a lot of companies have to make at the moment, not just western companies. And one of the more interesting reassessments about whether to stay or leave Russia was made by a company named DiDi Chuxing. DiDi is a Chinese vehicle for hire company headquartered in Beijing that is similar to Lyft and Uber, and has faced similar business model issues as Lyft and Uber, because they have a marginal business model that requires massive scale and a small percentage of profit from each ride that they can cross their fingers and hope to create a lot of earnings from. But that doesn't always work, as we have seen with Uber. So DiDi has been making some changes to its business model, which as Bentley Kaplan, who covers the transportation industry as well as co-hosting ESG Now with me, told me meant that DiDi wanted leave some unprofitable markets behind.

Bentley Kaplan:

To tackle costs and to try and trim the fat, the company's doing a few things. One is laying off a very big chunk of its workforce. It announced about 20% of employees are going to be sort of laid off. But it's also planning to exit a market where it, and incidentally Uber as well, have struggled to make profit, and that's Russia. So the timing of this was not something we can really speculate on, but it was a few days before Russia invaded Ukraine, DiDi announced that it would be exiting both Russia and Kazakhstan. But then five days later, which was after Russia's invasion of Ukraine, the company then announced that it was reversing its decision and it would remain in Russia.

And like the question of regulator pressure on the company and its de-listing from the New York Stock Exchange, which it's apparently planning to do, we can speculate on what's driving the factors here. But really, our role as ESG analysts and of company [inaudible 00:12:18] analysts is to point out where the business model risks will be. And for DiDi, for Uber, it doesn't really matter what market they're in, because their business model relies on personal data. It basically means that they can't escape this risk. And as regulator pressure increases, so investors will have to pay more attention to where that pressure could be coming from.

Mike Disabato:

And this isn't the first time DiDi has run afoul of regulators in China. One consequence of DiDi's, of Uber's, of Lyft's business model is a known one, the reliance on customer data. These companies accumulate data on where we are traveling, how often we travel there, and they are continually accumulating personal data which creates the issue of data security and privacy. So not only was DiDi having to deal with geopolitical considerations on whether it should leave Russia, but it also had to contend with the curtailing of its growth due to data concerns.

Bentley Kaplan:

Investors familiar with Europe would know very well the stringency of the GDPR, or the General Data Protection Act. Then all the sort of compliance sort of strings that came with that development. But China's also started taking a very hard look at data handling and data privacy. And the regulator to know about here is the Cyberspace Administration of China, or the CAC. And what have to DiDi, was that shortly after the company went through its IPO on the New York Stock Exchange, the CAC back in China announced a review of DiDi's practices. And within two days, which is a very, very quick timeframe, had ordered DiDi's app to be taken off local app stores. And that effectively stopped the company from signing up new drivers and new riders. As a result of this, there are questions being asked about whether there was political pressure involved in the regulator's action, given that DiDi opted to list in the US instead of China or in Hong Kong.

And indeed the company has announced that it now plans to de-list from the New York Stock Exchange and move to Hong Kong. And for all the intrigue that comes from that kind of announcement, or the conjecture we could spend time on here, for me as an ESG analyst it's really much more interesting to think about how a company's reliance on personal data created this regulatory risk in the first place, irrespective of what's actually nudging the regulator along and how dependent companies like DiDi and like Uber have become on these personal data sets that only seem to be getting riskier and riskier.

Mike Disabato:

Geopolitics and data collection often go hand in hand. But for DiDi, this has become a complicated problem that they're going to have to navigate as considerations are pushing and pulling them away from strict business considerations. And we will try to pay attention throughout their decision making.

And that's it for the week. I wanted to thank Bentley Kaplan for joining me to discuss the news with an ESG twist. I wanted to thank you so much for listening. I really appreciate it. If you like what you heard, don't forget to rate and review us wherever you get your podcasts. That helps me, that helps other listeners find us. And if you want to hear me every week, don't forget to subscribe. It'll automatically come into wherever you get your podcast. Thanks again, and talk to you next week.

Bentley Kaplan:

TRANSCRIPT

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.
