Defence: The great debate

Laura Blows explores the current scrutiny around investing in defence firms, and the increasing pressure pension funds are facing to defend their positions on the debate

Summary
- Focus on pension funds' investment in defence firms has increased since the start of the Russia/Ukraine war.
- There is debate on whether investing in defence is ethical or unethical.
- Pension funds have recently experienced greater, differing, pressure, from politicians and the public to invest/divest from defence.
- Trustees must act within their trust's law and fiduciary duties when considering the ESG issues of investing in defence companies.

On 24 February 2022, Russia launched the largest attack on a European state since World War II, with its invasion of Ukraine. Ever since that day there has been a heightened focus on European nations' defence, and in turn, pension funds' level of investment in the sector.

"Recent events have definitely refocused attention on the defence sector, not least because many countries, particularly in Europe, have significantly increased defence spending – in part to provide supplies to Ukraine and in part to reflect a greater sense of vulnerability and uncertainty," Redington head of stewardship and sustainable investment strategy, Paul Lee, states.

Ethical debate

Investing in the defence sector can be quite the moral quandary, with two opposing camps both interpreting the UN Sustainable Development Goal 16 – to promote peaceful and inclusive societies – in different ways.

One camp highlights that, as the Russia/Ukraine conflict has shown, without investment in strong defence systems, countries would be left at the mercy of aggressors; a surely 'unethical' thing to do. However, the other side believes that 'peaceful and inclusive societies' are not possible with the continuing investment of, and trade in, arms and weaponry.

For instance, the Global Alliance for Banking on Values (GABV) issued a Statement for Peace in February, calling on the financial industry to stop financing the production and trade of weapons and arms, stating that the "financing of weapons and arms does not

qualify for, and is at odds with, any definition of sustainable finance”.

According to the GABV, the financial sector invested at least $1 trillion between 2020 and 2022 to support the arms industry.

Meanwhile, the aerospace, defence, security trade association, ADS, states that the defence sector generates £9.8 billion in value for the UK economy.

According to its defence director, Samira Braund, ADS works in close collaboration with the government, defence industry and regulatory stakeholders “to advance environmental, social and governance (ESG) considerations”, such as through its UK Defence ESG Charter, which “provides a framework for greater ambitions around climate transition and clean tech; societal impact; and governance and ethics”.

“Despite this, many ADS members, especially SMEs, continue to report barriers to securing investment and access to financial services due to perceived ESG risk.

“Collaboration between industry, government and the investor community to secure the flow of capital heading into the sector is vital. It would ensure that the UK defence sector can provide the greatest value to investors as well as its necessary service protecting our freedoms and our way of life.

“We now need the financial sector to further recognise the immense social value the defence sector brings and work with us to evolve their investment strategies accordingly,” Braund says.

These opposing viewpoints can be tricky for pension fund investors to navigate from an ESG perspective.

However, the UK Sustainable Investment and Finance Association (UKSIF) is “clear-eyed about global geopolitical tensions necessitating strong national defences”, its head of governance and strategy, Madison Reamsbottom, states.

“But we believe investor freedom must remain central to protect sustainable investors. Institutions’ proprietary rules and approaches foster a healthy, robust and competitive ecosystem. Proprietary investment approaches should not be subject to political pressure,” she adds.

Increasing pressure

Investors, including pensions funds, have indeed recently been on the receiving end of government pressure to increase their investment in defence companies.

For instance, in November 2023, the government put out a press release highlighting its commitment to defend the defence industry from “ESG investors trying to immorally defund British defence”.

Commenting to defence industry leaders at the time, former Defence Secretary, Grant Shapps, said: “Investment in defence is the morally right thing to do, without which the atrocious activities of tyrants like Putin would go unchallenged and undeterred”.

The government was also bringing forward legislation that would have barred LGPS schemes from investing in ways that differed from foreign policy, “but that bill was dropped after the election was called, meaning that schemes are again faced with the need to reach their own decisions on these challenging questions”, Lee says.

In contrast to the political pressure to increase defence investment, pension funds are also receiving greater scrutiny, and criticism, of their involvement with defence companies by the public.

“This is certainly an issue that

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consumers are focused on, given the global implications of war,” PensionBee chief engagement officer, Clare Reilly, says.

“Consumers are interested to know whether their pensions are invested in companies active in war areas and how investment exclusions are applied, if at all.

“More recently, consumers have been interested in understanding the differences between the treatment of Russia and Ukraine and Israel and Palestine. In the case of Russia and Ukraine, widespread international sanctions have resulted in substantially reduced exposure to Russian-related assets in Western pension funds. The financial response to the war in the Middle East has not resulted in widespread exclusions, owing to a different global treatment of the conflict. The translation of geopolitical tensions into pensions can therefore be complex to explain,” she states.

According to Lee, "the situation in Gaza is an example of the challenges around this sector: A number of schemes, particularly in the local authority sector, are facing pressure from beneficiaries and other stakeholders about exposure to companies whose products are believed to be involved in perceived problematic actions".

For instance, in January, the OpenDemocracy website reported on Palestine Solidarity Campaign (PSC) figures, which stated that 52 of the 86 Local Government Pension Scheme (LGPS) funds across England and Wales have investments totalling £1.1 billion in firms supplying weapons or systems to Israel.

OpenDemocracy quoted PSC director, Ben Jamal, as saying: "It is a national scandal that the wages of local government workers are being invested in companies enabling these catastrophic attacks."

However, Lee states that "these arguments tend to be made from an ethical perspective, which is a hard basis for pension schemes to use as a motivation".

"While the recent Financial Markets Law Committee paper on pension scheme fiduciary duties and sustainability matters does encourage trustees to think about sustainability, and climate change in particular, it does remind them to do so through the lens of investment risk and return," he adds.

Sackers partner, Stuart O'Brien, agrees that trustees must act within their trust's law and fiduciary duties when considering ESG issues.

"Broadly speaking, these legal duties require trustees to exercise their investment powers for their 'proper purposes', namely the provision of members' pensions and to take account of factors that are relevant to that purpose, which will usually mean those which are financially material (this will necessarily involve the consideration of both risks as well as returns).

"Proprietary investment approaches should not be subject to political pressure"

"The law is generally restrictive on the circumstances in which it is permissible for trustees to take account of 'non-financial' factors in making any investment decisions and where these are not in the best financial interests of the scheme's beneficiaries," he explains.

"When looking at investment in the defence sector, trustees should keep these duties in mind. So, whilst trustees can reappraise their outlook on investment in defence industries where there is a sense that geopolitical shifts have changed the financial implications of investment, changing investment strategies to 'show support' or for other purposes will generally be off limits for trustees," O'Brien adds.

Investment considerations

However, the defence sector does come with some key ESG risks, and these should be assessed as part of investment decisions, as ESG risks are with any company, XPS Pensions Group senior investment consultant and head of ESG research, Alex Quant, warns.

"Specific ESG factors may be relevant, such as bribery, corruption, weak transparency or over supply of goods. As long as those issues are well-managed and accounted for in the valuation case, the overall business would not preclude investment," Quant says.

"Here it is key to distinguish between 'responsible investing' (integrating ESG into the investment process) and 'sustainable investing' (applying exclusions and/or tilting the portfolio towards sustainable themes). Many 'non-sustainable' funds do invest in defence stocks as those companies do meet the ESG criteria," he adds.

Indeed, it should not be assumed that 'ethical funds' automatically exclude defence firms, as Morningstar Direct research from April 2022 found that, amongst sustainable funds globally, just 23 per cent have a stated policy of excluding military contractors, with 44 per cent of sustainable funds having some exposure to military contractors (compared to 60 per cent for other funds).

However, few pension schemes have general barriers to investment in defence companies, Lee says.

"UK schemes do seek to exclude companies involved in indiscriminate weapons that are subject to international treaties, such as cluster munitions or anti-personnel landmines, but very few actively choose to go further than this," he explains.

"Some schemes will have investments in generic socially responsible funds that retain long-standing ethical bars on defence companies generally, and outside the UK some pension schemes (for example, many of those in Scandinavia) have exclusions on investing in companies involved in nuclear weapons and other products. But such broad approaches are rare in the UK, so that the only real exclusions are on cluster munitions and anti-personnel landmines. Depending which data provider a fund (or its managers) use, this will mean in practice the exclusion of a small handful of US and Asian companies from portfolios – somewhere between two and eight, typically," Lee adds.

It is argued that those companies in controversial or nuclear weapons are excluded on the basis they have significant and unnecessary social ramifications, and therefore do not meet 'do no significant harm' thresholds, Quant says.

"In sustainable funds there is often a revenue threshold associated with the exclusion policy, so that even if a small portion of a company's revenue is derived from, say, nuclear weapons, it will get excluded. This is where we have seen the greatest interest in schemes' exposure to defence companies, to ask why certain companies are excluded from sustainable passive funds, as they feel they do want to be exposed to conventional weapons as a valid investment sector," he continues.

Pension fund investors may well be more interested in the performance of defence companies, as "the sector has many attractive characteristics – not least enjoying long-term contracts with secure counterparties (national governments), Lee says.

"Some companies have implicit, or even explicit, government guarantees. The products are legal, and indeed can for the most part only be sold where the government gives its permission," he adds.

Due to recent geopolitical events, defence company valuations have increased and so "they have inevitably become greater proportions of pension fund portfolios", Lee continues, with most of the exposure to these businesses through public equity and debt portfolios "as all the largest *[defence]* businesses are publicly traded".

So, does this mean pension schemes are reevaluating their investment levels in defence firms?

"Well, there is certainly a heightened political spotlight on the UK's defence industry, which will understandably translate to a greater investor focus," O'Brien notes. However, "I am not sure it is yet becoming a trustee board talking point for smaller and mid-size schemes but no doubt larger investors with in-house investment expertise will be considering things", he states.

"Some investors such as charities may have stronger ethical views, which mean they don't want to invest in any areas of defence, but even in this space, we would expect this conversation to be client-specific depending on their beliefs, and possibly the views of the sponsor organisation," Quant says.

"These investors place this specific ethical position above their financial objectives – this is not to say their views will detract from their ability to meet their financial objectives, but they take a view that they can achieve their financial objectives without investing in such companies," he explains.

For those managing pension schemes looking to assess their investment in defence, Quant recommends that they undertake training to understand the various nuances that exist when investing in defence, such as the differences between controversial and conventional weapons.

"Trustees must act within their trust's law and fiduciary duties when considering ESG issues"

He also suggests that they take into consideration their scheme's 'beliefs' and their schemes' appetite to investing in defence.

They should then understand their current exposure to defence companies, through speaking to their consultants, and seek to change their investments, including their use of sustainable funds, if the current exposure level is not aligned to preferences. Finally, they should encourage and monitor engagement (by managers if in pooled funds) with defence companies to ensure transparency over the companies' activities, Quant concludes.

The UK defence sector may operate under one of the world's strictest export and licensing regimes, "but it is essential that in all instances funds invested in defence companies closely scrutinise export control systems and the risks associated with existing and potential end users", Reamsbottom states.

"These analyses must be ongoing and rigorous. Some will fail to meet the criteria and will be deemed too great of a risk. But some will not fail the standards, and there is currently no regulation in the UK's Sustainability Disclosure Requirements that precludes defence investment in all instances.

"There are material sustainability gains to be made in the defence sector, but each company and project must be assessed on a case-by-case basis to properly mitigate risk and identify opportunities," she explains.

Recent conflicts are undoubtedly placing a brighter spotlight on defence. Reilly notes that the increased focus on defence investment as a result of this "demonstrates that pensions are intrinsically linked to everything that happens around us".

Written by Laura Blows