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One year on, the war in Ukraine continues to shape ESG investing

Far from being confined to energy, the ripple effect of the invasion has reached aspects of sustainable investing such as engagement and the gap between ESG 'winners' and 'losers'.

BY MARGARYTA KIRAKOSIAN

The invasion of Ukraine has left a mark on ESG investing, from the challenge of allocating money to state-owned Russian enterprises like Gazprom, to the increased pressure on engagement policies to deliver.

Even before the full-scale war started, asset managers had been weighing up the risks of holding Russian companies, based on governance and climate concerns.

The investment team at Royal London Asset Management didn't have any Russian stocks at the start of the invasion, but it was concerned about the indirect exposure international companies might have.

'There are many other companies that derive some of their business and income from Russia due to the interconnected nature of the global economy,' said Ashley Hamilton Claxton, head of responsible investment at the firm.

Although more than 1,000 companies have curtailed their operations in Russia since last February, Yale School of Management identified 238 which are defying calls to exit or reduce activities.

These include multinationals like French consumer goods firm Bonduelle, Austrian banking group Raiffeisen and UK communication services group BT.

Moral Rating Agency, a non-profit based group in the UK, is tracking 122 large international companies that continue to operate in Russia. Its latest report showed that only 17 firms out of that group have made a complete exit.

'Our approach here has been to put controls in place to flag any trades in companies that were generating a material proportion of revenues from Russia, giving our investment teams the opportunity to review that company's exposure,' Hamilton Claxton said.

Engagement challenge

Investment firms often highlight engagement with investee companies as a core aspect of their sustainable credentials, but the war in Ukraine has demonstrated the limitations of this approach.

Sondre Myge, head of ESG at Skagen Funds, said the response in Scandinavia has been normative from the start: moving away from Russian equity markets as a matter of principle.

This also meant that Russian companies that were independent of the state became collateral damage.

'Because this response is inherently political, engagement and stewardship have largely been eschewed,' Myge said.

'The topic is of higher importance than what financial market participants can – and necessarily should – be able to influence,' he added.

Although Federated Hermes EOS looked at issues related to the war in Ukraine last year, it wasn't a big part of its activity.

Leon Kahmi, chair of EOS, said the exposure to Russian stocks for both the asset manager and EOS clients was minimal.

The team suspended engagement with five Russia-listed companies and two companies which had the majority of their assets in Russia. Those on the hitlist included Gazprom, Lukoil and Sberbank, as the potential for meaningful results was minimal.

Overall they contacted 118 companies in the month after the invasion started. By May, 87 had responded, and majority of those with links to the Russian economy made an exit.

'We thought it would be appropriate to understand from companies that had operations in Russia what they were doing and simply comply with the prospect of sanctions,' Kahmi said.

For the Federated Hermes team it was important to cover all potential human rights issues that might emerge and make sure the reputation and value of companies they were engaging with would be protected.

The stiuation was evolving so quickly that asset managers had to develop new engagement guidelines almost from scratch.

'We have had to react either in response to newsflow or because we feel we are not getting sufficient information from companies,' Royal London AM's Hamilton Claxton said.

'Disclosure has been everything in this context – as investors, we want to know what steps companies are taking and why,' she added.

Royal London has reviewed its approach to voting on director elections when it comes to companies operating in sanctioned countries or those owned by sanctioned individuals. It does this using a combination of subjective tests, external and internal research and checks on individuals using international sanctions databases.

'We assess each company and situation on a case-by-case basis, reflecting the fluidity of the situation and the potential for circumstances to change quickly,' Hamilton Claxton said.

Sectoral differences

The responses to engagement have not been universal across sectors. As part of the latest EOS engagement report, Kenny Tsang, sector lead for consumer goods, identified that energy companies came under the most pressure.

BP had to write off its investment in Rosneft, Exxon exited completely after Russia seized its assets, while Total Energies withdrew its directors from the board of its Yamal LNG partner Novatek as late as December last year.

Consumer and retail names such as Netflix, Amazon and Panasonic have suspended their services in Russia, while Nestlé chose to continue to supply essentials such as baby food, directing profits to support humanitarian relief in Ukraine.

A big question mark hangs over state-owned companies in China, especially those active in the oil and gas sectors that haven't issued public statements. The Yale School of Management highlighted Agricultural Bank of China as one of the companies still digging in.

The Federated Hermes EOS team is not allowed to give investment advice, in line with regulations, and can only communicate to the client that they haven't received a response.

'From the engagement standpoint if someone doesn't respond to you, you can't force them to,' Kahmi said.

Russia aside, Kahmi stressed a need to be discerning when dealing with state-owned enterprises, as some of them are interested in foreign investments and may listen to views that could make them potentially more attractive.

'You seek to appeal to business logic in putting certain things forward, so that they can make themselves more attractive. This can also be where there is a substantial ownership by the state,' Kahmi said.

Energy and weapons dilemma

Engagement aside, the invasion of Ukraine has redrawn the lines on what qualifies as ESG investing more generally, be it exposure to defence companies or fossil fuel producers.

'A direct implication is whether certain traditional "vice" industries are now more virtuous, for example weaponry and military contracting, with more asset managers now seeking higher exposure to such products,' said Skagen's Myge.

Being underweight traditional energy sources like oil and gas had a knock-on effect on ESG portfolios in particular, with sanctions on Russian companies leading to higher energy prices.

Stephen Metcalf, head of sustainable investing for RBC Wealth Management, said this resulted in some investors questioning the validity of sustainable investing, especially where it focuses on a rapid transition away from fossil fuels.

'However, we believe that this environment only adds weight to the case for an energy transition, and energy security, which is now a key factor in the transition.

'In short, while the effect of the conflict has led some to question the value of sustainable investing, we believe the proposition has only strengthened over the longer run.'

The energy shock, coupled with rising interest rates and inflation, has created a difficult environment for growth stocks, which for a long time were seen as ESG darlings. Myge said the public narrative about ESG 'winners' and 'losers' needs a reality check.

'This binary framing has largely been unhelpful to understand financial risks and opportunities, as we apply an ESG framework to all investment cases as part of being an active stock picker, where bottom-up analysis often uncovers important nuance,' he added.

The biggest challenge going forward, in his view, is that we are seeing the drawing of a new iron curtain that makes current and potential investments in certain economies challenging.

'Markets have become more political and whilst ESG at its core is about engaging in matters of political discourse, there is a greater sense of political divides emerging,' he said.

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