The Ukraine crisis and what it might mean for ESG and sustainable investing

Introduction

Firstly, our thoughts are with those impacted directly and indirectly by the events in Ukraine. The human tragedy outweighs everything else. However, we are understandably being asked by investors what the implications might be for ESG and sustainable investing as a whole. Questions are being asked such as:

- **Will this ultimately increase or reduce the focus on ESG in the future?**
- **What does this mean for investment into Russia, Ukraine and other countries?**
- **Will these events accelerate or slow down the push into green energy?**
- **Has the focus on 'Net Zero' led to the cost-of-living crisis, in other words has a focus on improving the E in ESG come at the cost of the S?**
- **Do these events highlight that there also needs to be more focus on the G within ESG as it pertains to governmental risk?**

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In this note we look to address some of these questions at a very high level. However, this is an incredibly complex topic that requires in-depth analysis, and ultimately there will be different views held by different investors and stakeholders. That has always been the case, but it is likely that views will become more extreme on either side of each argument, and there will be greater division between those that believe wholeheartedly in ESG and those that believe that the ESG movement is causing more issues than it is solving. This is simply mirroring the state of politics today throughout the world with increasingly polarised views on each side of almost every debate.

Comprehensive E, S and G policies ensure more sustainable long term value creation

Good governance and investment policies incorporate good ESG policies. A good ESG policy has always been balanced between all the major E, S and G issues. Corporate governance has long been a focus of many investors, even those that have not fully embraced ESG. But good governance is also a bedrock on which solid E and S integration is built. The fact that climate change has been at the top of many agendas in recent times, particularly given COP26, does not mean that E should be solely focused on climate, nor that it should trump S and G. Indeed, in some markets like the US, S has often been trumping E for many investors, with a greater focus on social injustice. And for Emerging Markets, a just transition approach has been leading the fiscal policy agenda.

The issue for investors is to balance a good ESG policy as an integrated part of all fiduciary responsibilities around maximising returns within an appropriate risk budget. Climate change has generally been an early beneficiary of this, particularly as climate-related risk metrics have improved. This will increase for more sustainability topics in the future. The recent introduction of TNFD (Taskforce for Nature-related Financial Disclosures) is a case in point. Similarly, the COVID-19 pandemic has increased urgency around health-related considerations, whilst bringing into focus other S and E factors such as social inequality, worker rights and biodiversity. The Ukraine crisis will and should catalyse greater scrutiny of a range of ESG policies, including stewardship, exclusions, divestments, and public policy engagements, in particular as they apply to the safeguarding of human rights, transparency, governance and the financing of and profiting from certain activities and alliances.

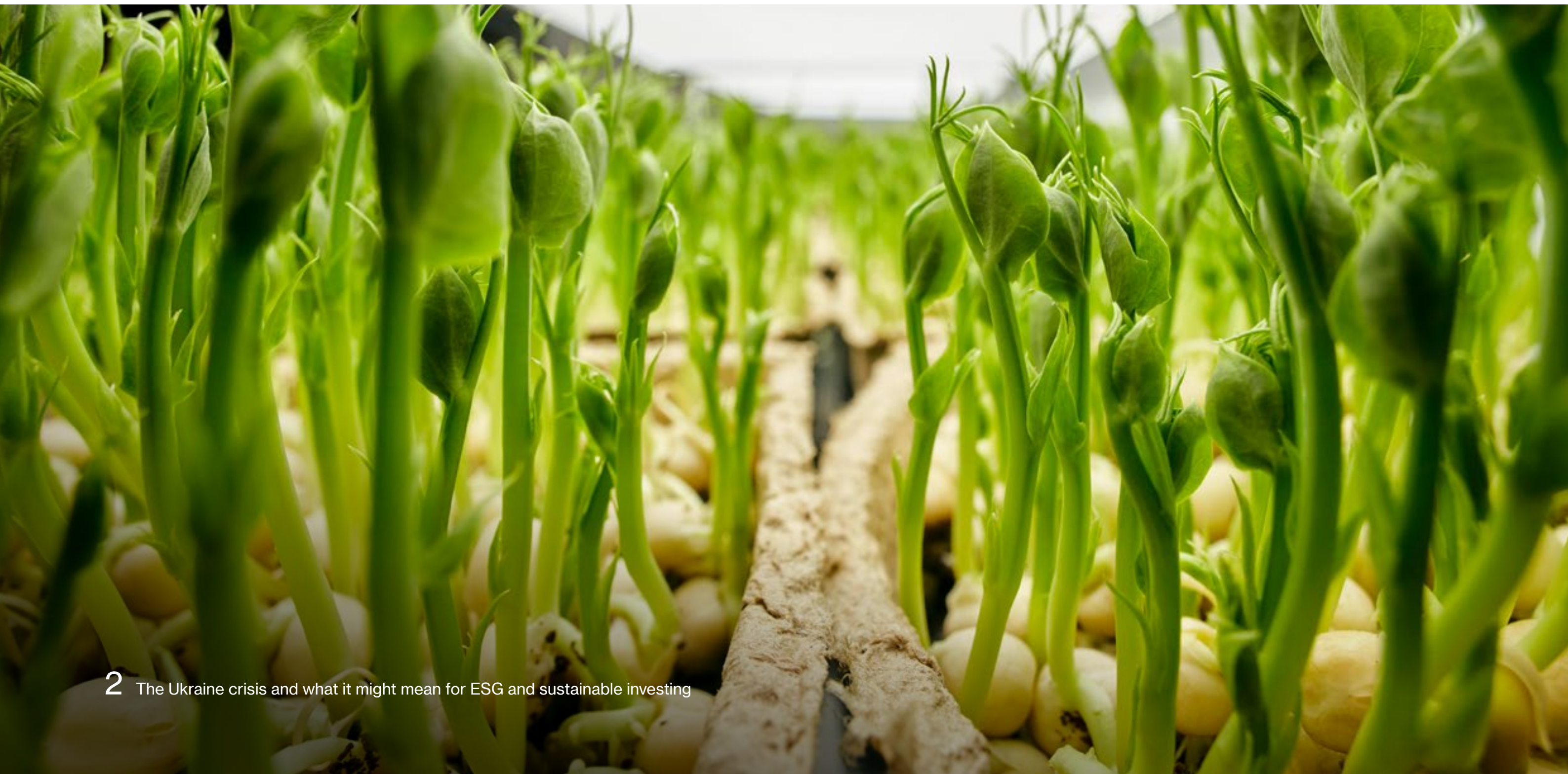
Governance and investment policy requires constant review and there is nothing like a crisis and global geopolitical uncertainty to stress test its efficacy. Where improvements are needed, governance and policies must be evolved to reflect changing risks to an investor's portfolio, people and the planet.

Several stakeholders are trying to draw comparisons between the crisis in Ukraine – and the financial and investment response – and other ESG issues and geopolitical risks. In this context, current policies and allocations in respect of China are raised, not least given many investors have recently increased direct allocations to Chinese assets[1].

Putting aside the clear differences between Russia and China's political regimes, it is also important to note that China is very different to Russia from an investment perspective, and it might not be appropriate to extrapolate what has happened in one situation and assume it applies in the other.

At the very least, China represents a much larger proportion of typical equity and bond indices than Russia did, so any policy to not invest directly in China is a much bigger investment decision. It could potentially also be more difficult to apply sanctions of the same degree to China than it has been to Russia given how embedded Chinese companies are in the global supply chain and the differing western nation trading partners.

[1]Source: WTW, 2022



Here we hit the limitations of ESG policy – it needs contextual consideration. The challenges are particularly acute given the global nature of investments, and the potential need to take into account domestic and foreign policy in every market.

Engagement and collaboration across investment-related and multi-stakeholder initiatives remains more critical than ever.

The complexity of the issues demands diversity of solutions – that's why WTW continues to support initiatives like Glasgow Financial Alliance for Net Zero (GFANZ), Net Zero Asset Managers Initiative (NZAMI), Investment Consultants Sustainability Working Group (ICSWG), Principles for Responsible Investments (PRI) and many more.

ESG issues are financial issues

We have argued for some time that it is essential to fully embed ESG issues in any investment process because they could have profound impacts on expected returns and risks. Recent events have highlighted that again, with any Russian holdings having essentially been written down to zero as index providers around the world have removed the country from their indices following the introduction of sanctions and the drying up of liquidity as a result. A strong policy on S and G may have led to exclusions prior to the crisis at the extreme, or at the very least caution in a significant overweight to Russia.

However, for balance, some would argue that whilst it is easy to say that in hindsight, such policies, if applied consistently, would arguably lead to disinvestment from multiple other assets which make up a larger proportion of typical equity and bond indices.

There is no simple ESG policy, particularly as it relates to oppressive regimes in a highly interconnected world. However, reflecting some of these risks in asset valuations seems a minimum requirement.

The 'Net Zero' movement continues to gather pace

Those investors that do not wish to embrace ESG have in some cases blamed the energy price spikes on the "Net Zero" movement. Indeed, some are arguing that those focusing on the E of ESG have actually led to more S issues, such as the current cost-of-living crisis in certain countries.

On the other hand, those that have been advocating the 'Net Zero' movement for some time will understandably point out that recent events have only served to highlight the fact that Europe's current reliance on imported gas (and other fossil fuels) is the very reason why energy markets are failing on three fronts – failing to protect future generations from the devastating effects of climate change, failing to deliver a cost of energy that people can afford and failing to deliver long term energy security. The argument here is that had the 'Net Zero' movement caught on earlier we might not be in the perilous position we are in today. And growing momentum of the 'Just Transition' movement is ensuring that the S is addressed alongside the E.

Most governments appear to be moving closer to the second argument, with recent announcements from Germany around the desire to target green energy being a good example. Much of the voting public in western nations are also pushing their governments in this direction. And at the same time, wind and solar are becoming in many instances the cheapest forms of energy, with the costs continuing to fall and tools now available to manage the fact that the wind doesn't always blow and the sun doesn't always shine. Therefore, it is difficult to see a halt to progress towards Net Zero. It is clear that this is both a return opportunity and a risk mitigation issue that needs to be managed by investors.

Summary

Even those investors that have historically not been keen to fully embrace ESG have seen this situation as one that they need to address. Many investors instructed their managers to sell all Russian and Belarussian assets where they could (not just sanctioned companies), and many have introduced a restriction on purchasing more assets in those markets for the foreseeable future.

The more difficult decision for investors might be what to do with Russian assets that have not been sold and have been written down to almost zero once liquidity returns and some sanctions are potentially lifted.

From an ESG perspective, it could be argued that recent events have not really changed the fundamental thesis about sustainable investment, but rather that most people have even stronger views on ESG topics than they did before. Those that were anti-ESG before are now very anti-ESG and will make bold claims that there is proof that it doesn't work. Similarly, those that were pro-ESG before will now be arguing recent events are further proof that the world needs to speed up the ESG movement. Given that many investors have already started to incorporate ESG factors into their approach, it is likely that this will continue at pace, but with some strong or vocal exceptions.

The 'Net Zero' movement is unlikely to slow down now, but there will almost certainly be a lot more noise around it. It is important to note that a good investment policy around 'Net Zero' is not based on simple decarbonization in the short term anyway. It is about properly pricing in climate risk, engaging with assets in a proactive and constructive manner, investing more in climate solutions over time and reducing greenhouse gas emissions over the next thirty years in a way that is consistent with the goals of the Paris Agreement. That doesn't mean having to always be ahead of that trajectory at every point in the next thirty years. There will be times where that doesn't make good financial sense, in the same way that there will be times where you want to be way ahead of that trajectory.

The debate as to whether the events in Ukraine will impact the decision to invest in many other markets will also continue for some time. There is no right or wrong answer, and as such there is likely to be some divergence in approach among investors. The key is that the E, S and G risks are appropriately considered by investors in making strategic and portfolio decisions.

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