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Russia's invasion of Ukraine: ESG & Sustainability implications

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IN A NUTSHELL

Within this report, we assess the potential implications following Russia's invasion of Ukraine from an ESG and sustainability perspective. We argue that the 'democratisation of capital', which characterized the world system following the collapse of the Soviet Union may have come to an end. Investors need to consider that we have seen 16 consecutive years of decline in global freedom such that today 38% of the world's population live in "Not Free" countries, the highest proportion since 1997. Our conclusions are:

_ **ESG and Sustainability considerations will become more relevant for investors following the invasion of Ukraine.** Companies cannot just look at the maximization of financial returns without taking into consideration Governance and Social components of the countries they operate in and with whom they do business with. Milton Friedman's belief that the only responsibility of companies is to maximise financial returns[1] is, put simply, a relic of the past, as we have argued previously[2]

_ **The definitions and thresholds for sustainability and ESG investing will evolve towards investors taking on greater responsibility for system stewardship.** Asset owners, both at an institutional and retail level, are likely to face more scrutiny. They will be expected to encourage, on behalf of their investees, governments and society to improve social practices, governance standards and regulations regarding the rule of law, democratic practices, corruption, human rights, equality, alongside environmental and climate priorities

_ **Ethical considerations will become more prominent in assessing financial Intermediaries.** The primary focus will be on ensuring a match between the ethical standards of the providers of capital and the ultimate user of that financial capital at funds level, but questions will be asked if an intermediary is involved in other controversial businesses and practices

_ **We expect investors' attitudes will shift and become more conservative.** Investors may no longer provide the benefit of the doubt to companies and countries that have been sitting on the fence or providing implicit support to autocratic regimes

_ **Defense spending is becoming more acceptable in Europe** as the idea of a 'free' world fades away, possibly paving the way to changes in investment taxonomy for European sustainable funds

_ **Investors and politicians will accelerate efforts to become clean energy independent** through renewables and energy efficiency, but in the short-term higher coal usage is on its way as environmental risks may take a backseat versus national security

[1] Friedman, M. (September 1970). The social responsibility of business is to increase its profits" The New York Times Magazine

[2] DWS Research Institute (September 2020). Stakeholders and shareholders: Why Milton Friedman got it wrong.

Overview

Ever since the collapse of the Soviet Union and following China's entry to the World Trade Organization in 2001, capitalism entered a new chapter, where production would take place in one location while consumption was undertaken elsewhere. Large trade imbalances would be accepted under the premise of common prosperity and which would become the world's new and improved economic system. The underlying presumption was one where the Western Economic Model based on democratic institutions and the respect of international laws would eventually become the norm in the most important developing countries in the world, including countries that were previously following the Communist model.

At first glance, this western economic model has reigned supreme as the idea of global capital was not dented by the events of 9/11, which was deemed as an attack on the western capitalistic model. Nor was it derailed by the 2008 financial crisis, and it has so far proved resilient to the COVID-19 pandemic. But the model, which we define as the 'democratization of capital' and which has supported capital flows over the past 35 years, may now recalibrate in the wake of Putin's war in Ukraine.

Democracies are built on the separation of powers, ensuring that there are proper checks and balances in place to avert any abuse of powers. This is relevant for the capitalistic model, which is also built on the separation of ownership from control[3]. The independence of such roles and institutions plays a pivotal role in the democratization process.

Society, investors and the private sector have taken this model and its benign assumptions for granted. If the independence of institutions did not exist in communist states and elsewhere, it was expected that they would be created and would eventually take hold to ensure the proper governance and working of capital markets.

This naïve assumption or misplaced optimism that financial capital would deliver democratic institutions may have its origins in the successful integration of many eastern European countries into the European Union between 2004 and 2013. But what we have witnessed elsewhere and for more than a decade has been an issue of 'form versus substance', that is to say, institutions which give the impression of a democratic state, but their lack of independence means any trace of democracy is an illusion.

In hindsight, there have been many examples over the past decade that have indicated that we passed the peak when it came to the "financial capital driving democratization" movement. For example, the suppression of the 2011 Arab Spring protests, Russia's annexation of Crimea in 2015 and a tightening in controls on societies and freedoms in countries as far afield as Afghanistan, Hong Kong, Nicaragua, Turkey, Sudan and Venezuela. According to Freedom House[4], we have witnessed 16 consecutive years of decline in global freedom such that today 38% of the world's population live in "Not Free" countries, the highest proportion since 1997. Even India, hailed as the world's largest democracy, was downgraded last year from a "free" to only "partly free" society following discriminatory policies affecting the Muslim population and crackdowns on the media, academics and civil society groups[5].

When it comes to Russia, it is argued[6] that the private sector's prioritization of market reforms instead of political reforms after the collapse of the Soviet Union shaped the trajectory of Russia's development. It was the notion that market liberalization would somehow lead to a proper working of capitalism and political reform.

[3] One may own a share of a company but it is managed by people specialized in their field and a number of institutions are either ensuring the proper operation of capital markets (exchanges, accountants, regulators) or facilitating the flow of capital (brokers, financial advisors, portfolio managers).

[4] Freedom House (2022). Freedom in the world 2022. The global expansion of authoritarian rule

[5] Freedom House (2021). India: Country Profile

[6] Katharina Pistor (February 28, 2022) From Shock Therapy to Putin's War

But, there have been serious questions of the effectiveness of the ‘benefit of doubt’ approach which has allowed Russia to become part of major investable benchmarks. This has been permitted on the basis that allocating capital to Russia is equivalent to investing in US or Western European stocks. This idea needs reassessing given the intrusion either directly or indirectly of the Russian government in Russian listed companies’ operations. Our own analysis reveals that of the 25 securities in the MSCI Russia benchmark, 12% are more than 50% owned by the Russian state with an additional five more companies (20% of the benchmark) where the Russian state has significant influence.

When it comes to Russia’s views on western institutions such as NATO and the country’s intentions towards Ukraine, these have been revealed many times this century. For example, in Putin’s speech at the Munich Security Conference[7] in 2007, the annexation of Crimea in 2014 and the Russian President’s essay on Russian-Ukrainian relations published last year[8].

The tragedy has been western governments and investors have not been giving the benefit of doubt. If they had listened and acted, then the current situation could have been avoided and some mistakes avoided. For example, over the past eight years the EU’s dependence on Russian gas has risen by 24%[9].

This means that the western response to the invasion of Ukraine is being questioned because of the difficulty of putting in place effective sanctions against Russia given Europe’s dependency on Russian oil and gas and the misplaced belief that sanctioning Russian economic oligarchs would increase calls within Russia for Putin’s removal.

An analysis[10] of the oligarch structure in Russia, differentiating between ‘economic’ and ‘strong men’ oligarchs also suggest that economic oligarchs do not actually own the wealth that is attached to their names. Rather, they will only be able to enjoy their apparent wealth under the condition of supporting the Russian government. As has been seen time and again, when Russian economic oligarchs criticise the Kremlin, their assets and freedoms are simply taken away.

As a result of the above, we expect, following the invasion of Ukraine, investors to begin focusing on the political aspect of capital flows, of where the capital is operating and the political willingness of the hosting nation to promote and develop a full democratic system, based on the separations of powers and proper governance. This will mean greater scrutiny when it comes to the track record of countries in the areas of human rights and corporate governance and ultimately a stronger stance may be taken by investors on capital allocation particularly as it relates to emerging markets.

The recalibration of the western economic model will therefore continue, but some adjustments will occur faster than others. Within the remainder of this report, we analyse why that may be required and in what form they are likely to take.

[7] Politico (February 2018). The speech in which Putin told us who he was

[8] President of Russia (July 2021). Article by Vladimir Putin “On the historical unity of Russians and Ukrainians

[9] Eurostat 2022

[10] Guardian (March 8, 2022). The sanctions strategy is flawed. To defeat Putin, you have to know how the Kremlin works

Our conclusion is that:

_ ESG and sustainability factors will become even more important post the Ukraine crisis. In fact, this is something we had already highlighted in a DWS 2019 report[11] *Why emerging markets are defined by ESG*

_ Grey zones within the world of investments will not be casually overlooked. Take the recent UN resolution on condemning the Russian attack of Ukraine. While Russia naturally blocked it, China, India and the UAE abstained. The obvious question is whether a country can remain neutral on such issues, yet still arguing that the underlying principles of western democracy and good governance apply. Investors and citizens in these countries are likely to take a dim view. Other grey zones that will receive greater scrutiny include corruption, autocratic countries and human rights.

_ The western world has a unique opportunity to accelerate investment into renewable energy projects and energy efficiency and gain clean energy independence from Russian (and potentially broader) fossil fuel imports. This will have considerable economic and political impact given the reliance of the Russian economy on the fossil fuel sector and may have an impact on the external threat posed by Russia

_ The definition of 'sustainable & ESG investment' will evolve. We have seen an overnight change in what is viewed as material to the 'sustainable' and 'ESG' investor. Energy independence is now back to the top of the policy agenda in Europe. Investments in some arms and defense companies may become acceptable in future sustainability frameworks. The next step of evolution is likely to be stronger action by investors on system level stewardship

The report is structured into the following sections that help underpin the arguments highlighted above.

1) European clean energy independence

2) Sovereigns, ESG, sustainability and authoritarianism

3) A framework for ESG and sustainable investments at a nation state level: system stewardship

4) The increasing importance of "S" and "G" for global investors

[11] DWS Research Institute (October 2019). Why emerging markets are defined by ESG (dws.com)

1 / European clean energy independence – a case study of market reforms without political reforms

If one looks at the export and import picture for Russia in **Figure 1**, we see how integrated and specialized the economy has become. Regarding Russian exports, the bulk of these are in oil and gas alongside other commodities such as precious and other metals. In terms of imports these are led by machinery & applications (broadcasting equipment, computers), transport vehicles (cars, vehicle parts), and pharma & chemicals. Russia's top import partners are China (23.0%), Germany (11.9%), Belarus (5.8%) followed by the South Korea (3.6%) and Italy (3.5%).

FIGURE 1A: RUSSIAN EXPORTS BY COMMODITY
(%, 2020)

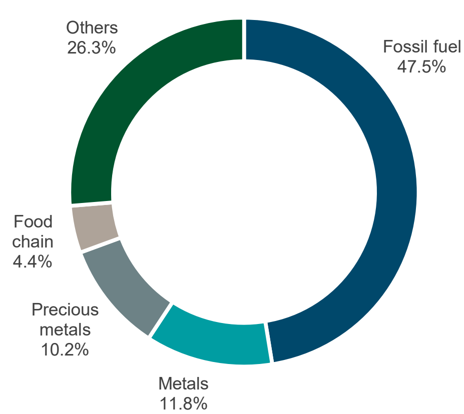
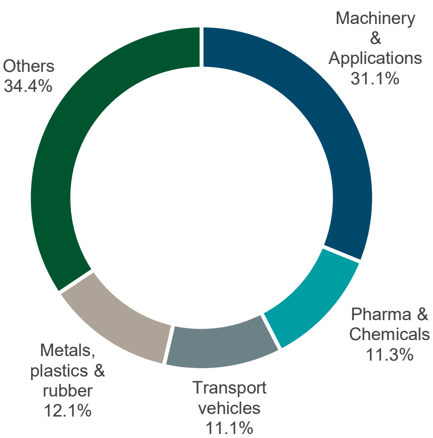


FIGURE 1B: RUSSIAN IMPORTS BY COMMODITY
(%, 2020)



Source: OEC (data for 2020)

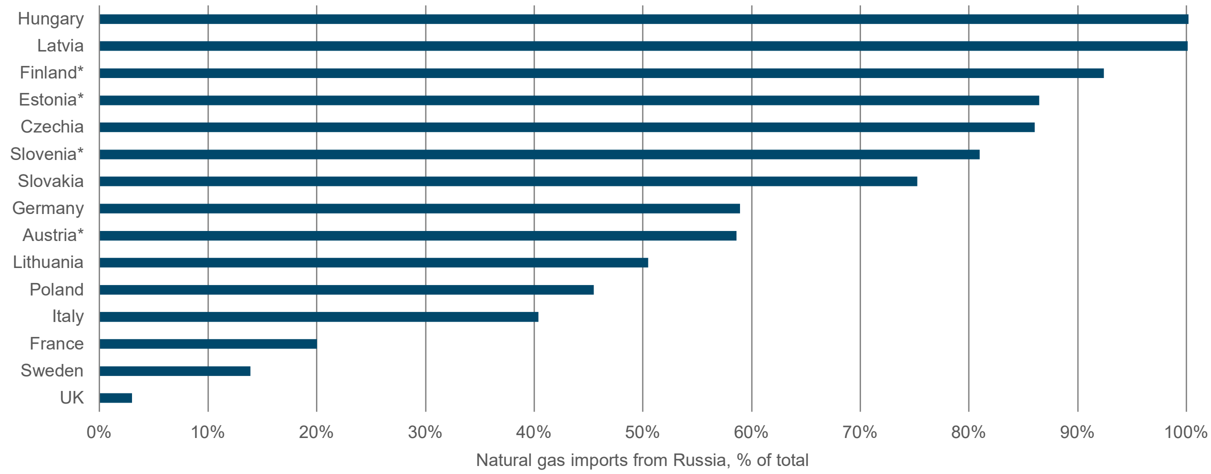
Five days after Russia's invasion of Ukraine, European energy ministers met[12] and agreed to provide practical support to Ukraine, strengthen the resilience of Europe's energy system and accelerate the green energy transition. Investors and other stakeholders will be watching closely to ensure European policymakers do not repeat the mistakes of the past.

It has been eight years since Russia's annexation of Crimea, over which time the EU's dependence on Russian gas has increased by 24%[13.] Over the same time-period, Europe's dependency on Russia oil has dropped by 21.6%. European demands on Russian natural gas imports are illustrated in **Figure 2**. It shows that Hungary, Latvia and Finland imported almost all their natural gas from Russia last year. In the case of Finland and Latvia, this dependency is countered by the fact that these countries have a relatively low share of natural gas as a proportion of their total energy demand at less than 20%.

[12] European Council (February 28, 2022) www.consilium.europa.eu/en/meetings/tte/2022/02/28/

[13] Eurostat 2022

FIGURE 2: THE SHARE OF NATURAL GAS IMPORTS FROM RUSSIA BY COUNTRY (2020)



Sources: Eurostat (including estimates for non-reported data). *Assumptions were made for countries that have not identified imports from Russia. For UK, the number is for 2021, sourced from House of Commons Library.

More vulnerable perhaps are those countries where natural gas constitutes a larger share of total energy consumption for example in Germany, Hungary and Italy where Russian natural gas imports are high and natural gas represents more than a quarter of total energy consumption. Italy, for example is planning to diversify its sourcing of gas in the short term from Russia to countries such as Tunisia, Algeria and Libya and to increase the capacity of gas imported from Azerbaijan. But these remain part of a cluster of countries which the former U.S. President Barack Obama once described[14] as 'volatile countries'.

More recently, Italy's Prime Minister, Mario Draghi, has recently highlighted[15] the need to speed-up the development of renewable sources. Russia's invasion is also a long overdue chance to deliver a new and stronger EU Climate and Energy Security Strategy. The European Commission's publication of the REPowerEU [16] strategy, aims to make Europe independent from Russian fossil fuels, well before 2030.

If the rationale for reducing dependence on fossil fuels from 'volatile' countries on geopolitical risks are now clear, the recent 3,000 report by IPCC warning of the 'unequivocal climate threat' to human and planetary health[17] means that, in a nutshell, the need to rapidly shift to a near zero emissions society is stronger than ever.

Still, despite the benefits, the path to a European transition remains fragmented. While it is beyond the scope of this paper to highlight all the issues attached to this, here is a short list:

_ The estimates made by the EU on the additional investments required for the energy transition are too high because of a high discount rate assumed
_ The proposal made to renovate buildings and make them efficient when they are sold makes sense[18]. But the minimum energy efficiency standard is far too weak

[14] Barack Obama (2006). The Audacity of Hope: Thoughts on Reclaiming the American Dream

[15] Reuters (April 2, 2022). Italy to look at speeding up green light for renewable projects

[16] EU Commission (March 2022). Joint European action for more affordable, secure energy (europa.eu)

[17] IPCC (February 2022). Climate change: a threat to human wellbeing and health of the planet. Taking action now can secure our future — IPCC

[18] Dodge Data & Analytics, World Green Building Trends 2018

- Over 450 financial institutions responsible for over USD130 trillion in assets have committed to net zero and getting off fossil fuels[19], but European policymakers have so far missed an opportunity to align building and Taxonomy regulations with the metrics increasingly used by these financial institutions regarding net zero real estate
- A stronger European climate and energy security strategy should also include mortgage portfolio regulations[20] that would reinforce the leadership of the 70 banks participating in the Energy Efficient Mortgage Initiative[21]. But again, this will take time

What that means is that Europe needs to rapidly diversify gas suppliers (even from other non-democratic countries) and accelerate investments in solar and wind. At the same time, given the volatile nature of the current list of natural gas suppliers into the EU, we expect that natural gas will continue to be seen as an energy source to be phased out over the medium to long term particularly given the recent parliamentary vote in the European Parliament[22].

Russia's invasion has therefore changed Europe's paradigm in many ways for the worse. An equally strong paradigm change is necessary to help Europe's climate and energy security policies to start reducing the continent's dependence on fossil fuels and making the region's buildings healthier to live in. A greener, more habitable world that does not enrich dictators could be a welcome outcome.

Looking at the Russian state, **Figure 3** classifies publicly listed Russian equity according to their ownership structures. It reveals just how small the number of Russian listed equity are classified as "free", that is outside the ownership of the state or the economic oligarchs. The Russian state consequently has influence across large parts of the economy and most notably operations in the oil and gas, power, mining, shipping and banking sectors. Any thought that the freezing oligarch-controlled in their assets in western financial centres and vacation spots might pressure the Kremlin to alter its course on Ukraine is likely to be misplaced. These economic agents and their security is safeguarded by their personal relationship with the Russian president[23]. This would suggest that a strategy to reduce oil and gas revenues flowing from western Europe to the Kremlin needs to be developed as a matter of urgency. In our view, this would be facilitated by a more forceful EU strategy relating to energy efficiency and renewables.

FIGURE 3: OWENERSHIP STRUCTURES OF RUSSIAN LISTED BY MARKET CAP (FEBRUARY 2022)

Category	Market Cap	Proportion
Free	16,096.50	3.00%
Government – minority stake	79,644.10	15.00%
State owned	171,036.90	32.10%
Oligarch controlled	265,467.60	49.90%

Source: DWS Investment GmbH (22 April 2022); Bloomberg Finance LP (Pre-crisis data as of 22-Feb-22)

[19] GFANZ 2022 https://www.gfanzero.com/about/

[20] Climate Strategy and Partners 2021 https://www.climatestrategy.es/press/MortgagePortfolioStandardsREPORT2021.pdf

[21] EEMI 2022 https://energyefficientmortgages.eu/

[22] European Parliament (June 14, 2022).Taxonomy: MEPs object to Commission's plan to include gas and nuclear activities https://www.europarl.europa.eu/news/en/press-room/20220613IPR32812/taxonomy-meps-object-to-commission-s-plan-to-include-gas-and-nuclear-activities

[23] Guardian (March 8, 2022). The sanctions strategy is flawed. To defeat Putin, you have to know how the Kremlin works

2 / Authoritarianism, Sovereigns, ESG and Sustainability

This section examines the nature of sovereign ESG ratings and objectives, authoritarianism, and investor activity. The focus is on two aspects, first the expansion of authoritarian rules and restriction on freedoms, second, the merits and risks of the current ESG methodology.

2.1 The rising risk of authoritarian regimes and implications for investments

Freedom House[24] found that "*Authoritarian regimes have become more effective at co-opting or circumventing the norms and institutions meant to support basic liberties, and at providing aid to others who wish to do the same. In countries with long-established democracies, internal forces have exploited the shortcomings in their systems, distorting national politics to promote hatred, violence, and unbridled power. Those countries that have struggled in the space between democracy and authoritarianism*". Data shows that the level of freedom declined in sixty countries and only improved in twenty-five over the past year. We find that the level of freedom has been declining for the past sixteen years. Moreover, 38% of the world's population live in 'Not Free' countries the highest proportion since 1997 with just 20% of the global population living in 'Free' countries. During this period of democratic decline, checks on abuse of power and human rights violations have eroded.

There is no easy or quick solutions to these challenges, Russia's invasion of Ukraine is a wake-up call to financial institutions and public sector development institutions. A greater dialogue and cooperation between the public and private sectors to strengthen sustainable economic development efforts and combat the growth of authoritarianism ought to be the way forward, but this will be a challenge as the FT's chief economics Martin Wolf commentator has stated that "tyrants can be good for business". But investors have a role to help address political disfunction in developed through a more proactive approach to governance[25]. In a global market, it is essential that the underlying principles and savings of the providers of financial capital are fully aligned with the ones that require it. Given the appealing dynamics with regard to human rights and freedoms over the past sixteen years, the benefit of doubt that has characterized the current approach, ought to be revisited and ensure that interests and objectives are broadly aligned.

2.2 A new more balanced approach to ESG data for developing economies is required

Within this context, it is essential to assess how current data and methodologies assess risks and opportunities in developing economies.

The World Bank[26] has published a series of reports on different topics around sovereigns, ESG ratings and sustainability. Their conclusion is that "Unclear terminologies, overlapping concepts, and opaque scoring methodologies raise fundamental questions about the outcomes of ESG investing compared with the stated goals." [27].

The World Bank noted that investors may have different motivations between financial risk management or sustainable impact, so it was recommended that data providers clearly define the focus of their scoring. Clarity is needed on the

[24] Freedom House (2022). The global expansion of authoritarian rule https://freedomhouse.org/report/freedom-world/2022/global-expansion-authoritarian-rule

[25] Raj Thamotheram (October 2020) IPE: Long term matters: Addressing autocratic risk

[26] World Bank (December 2020) Demystifying Sovereign ESG https://openknowledge.worldbank.org/handle/10986/35586

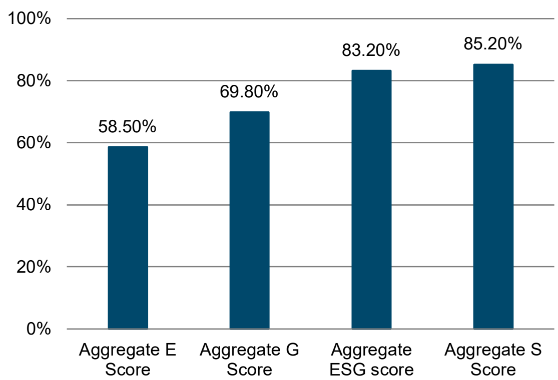
[27] World Bank (June 2021) A New Dawn: Rethinking Sovereign ESG https://openknowledge.worldbank.org/handle/10986/35753

investment objective that a specific data methodology is being used for. Improved data, incorporation of forward-looking scenarios and removing the bias on a country's level of economic development are therefore required.
This is an issue that we have highlighted in the past (see water report), i.e. that the outcome can be very different if one uses an 'outside-in' or an 'inside-out' approach to ESG and sustainability.

Their analysis of six different ESG data providers found that there was significant score convergence with greatest divergence of Environmental scores due to poor environmental data quality. The World Bank concluded that ~80% of a country's ESG score was explained by the country's level of economic development: an ingrained income bias, as shown in **Figure 4A**.

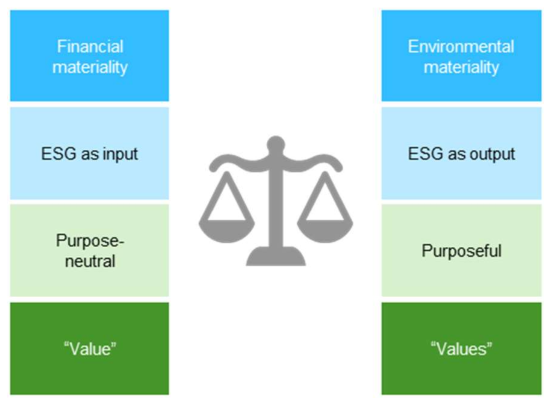
Failure to account for this bias would lead to misaligned incentives and could lead to investor prioritization of more developed countries compared to developing countries which need most investment. Other sustainability related rankings of this country also have an income bias.

FIGURE 4A: CORRELATION OF SOVEREIGN ESG SCORES WITH NATIONAL INCOME (GNI PER CAPITA)



Source: World Bank 2020

FIGURE 4B: ESG VS SUSTAINABILITY: DIFFERENCES ARE MISUNDERSTOOD BUT IT IS NOT AN "EITHER–OR" DECISION



Source: World Bank 2021

The World Bank suggests that clarity is needed on investor goals and the data used as shown in **Figure 4B**. The World Bank recommends a Sovereign ESG 2.0 strategy to address these shortcomings.

A key part of a new approach should address the challenge that very few Emerging Market sovereigns can attract significant international investment into their local currency sovereign debt markets. Multilateral development banks thus continue to play a key role.

We agree with the World Bank that development banks and international financial institutions need to deepen their cooperation. Governments in development countries need to continue to support, in cooperation with development banks and private financial institutions, their respective countries efforts towards sustainability.

3 / A framework for ESG and sustainable investments at nation state level: system stewardship

In a globalized investment world, investors have much greater responsibility to use their capital and influence towards governments and other “rule/standard setting” organisations. They should embed democratic principles in their approach, rather than assume the market is fully functioning and will take care of it.

This can encompass a broad range of priorities including the status of democracy and the rule of law, corruption, human rights and equality, and state regulations, incentives and penalties for environmental impacts. These systemic issues affect systematic risks in portfolios and human livelihoods: the ultimate beneficiaries or clients of the investment system.

Within this section, we present the growing number of initiatives that are encouraging and supporting investors to undertake system level or systemic stewardship. And we present recommendations for how more investors could work to address the wide variety of environmental and social systemic issues in our society.

3.1 Why investor engagement on sovereign policies and practices matter

It can be argued that the western’s lack of focus on Russian nation state policies and behaviours influenced Russia’s post-Soviet trajectory.

After the collapse of the Soviet Union, financial institutions and companies insisted on market reforms over political reforms[28]. However, this market driven focus at the expenses of political reforms may have failed as it resulted in turning a blind eye to the laundering of money from autocrats and oligarchs, which some argue influenced Russian politics[29] and may have contributed to the conditions have that has led to the invasion of Ukraine. This includes Russian influencing politics outside its borders and undermining western democracies through funding and close connection with populism movements (Italy, France, Hungary).

Political risk is usually considered as external to portfolios: investors try to understand and price the risk but do not try to change the risk. This is what ESG investing is about: integrating external Environmental, Social and Governance risks into investment decisions.

[28] Katharina Pistor (February 28, 2022) From Shock Therapy to Putin’s War

[29] Oliver Bulloch (2022) Butler to the World https://profilebooks.com/work/butler-to-the-world/

FIGURE 5: A BROADER VIEW TO ESG INVESTING

Several authors, initiatives and think-tanks are encouraging and supporting investors to take a broader view:

_ "*Beyond Modern Portfolio Theory*": Written by Jon Lukomnik who was one of the pioneers of modern corporate governance and pursued a successful investment career. Along with James Hawley (Head of Applied Research at Truvalue Labs, a FactSet company), they have written a compelling narrative.

They argue that there are paradoxes to Modern Portfolio Theory (MPT) as developed by Nobel Prize winner Harry Markowitz in 1952. MPT states that an investor cannot diversify away from systematic risks and that systematic risks determine 75-94% of a portfolio returns but this leaves very little risk that can actually be diversified by an investor. The second paradox is that portfolios and investing activity do affect systematic risk in many ways, with many feedback loops.

Many of the largest investors actively seek to mitigate environmental, social and financial systemic risks which often cause systematic capital market risks. These investors' actions seek to address the overall risk/return profile in the market and can also aim to improve living conditions.

The investment strategist Roger Urwin of Willis Towers Watson wrote[30] in 2011:

> "*Universal owners are asset owners who recognize that through their portfolios they own a slice of the whole economy and the market. They adapt their actions to enhance the return prospects of their portfolios, and hence the prospects for the whole economy and the market as well. This approach is a logical but ambitious interpretation of investing sustainably. Universal owners focus their actions particularly on active ownership practices and active investment strategies that integrate ESG considerations.*
>
> *For universal owners, overall economic performance will influence the future value of their portfolios more than the performance of individual companies or sectors. This suggests that universal owners will support the goals of sustainable growth and well-functioning financial markets. A universal owner will also view these goals holistically and seek ways to reduce the company level externalities that produce economy-wide efficiency losses."*

Most investor stewardship activity has focused on company-by-company engagement: i.e. please improve your board's gender diversity, please set a climate target, please pay a fair wage to workers in your supply chain. Such activity is important and is having a positive impact of society, it is also insufficient. Companies nor investors can establish a carbon market that prices externalities. And even if a few big companies are encouraged to establish a bribery and corruption policy, this will not address overall levels of corruption and money laundering in countries.

In 2014, the PRI published "Case for Investor Engagement in Public Policy"[31]. A foreword from Adair Turner, former Chairman of the Financial Services Authority stated:

> "*Individual and voluntary action alone cannot deliver a financial system appropriately focused on long-term objectives. Public policy is also needed. Without public standards on disclosure of risk, less responsible companies and investing institutions may enjoy short-term advantages. Without a clear commitment to robust carbon pricing, the incentives to develop clean energy and improve energy efficiency will still be too weak. Financial institutions which want to adopt long-term horizons and to act responsibly in investors and society's long-term interest, cannot therefore avoid engagement in the public policy debates which will shape the context in which they operate."*

Source: DWS Investment GmbH (June 2022); *Beyond Modern Portfolio Theory* Jon Lukomnik

[30] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829271

[31] https://www.unpri.org/download?ac=1420

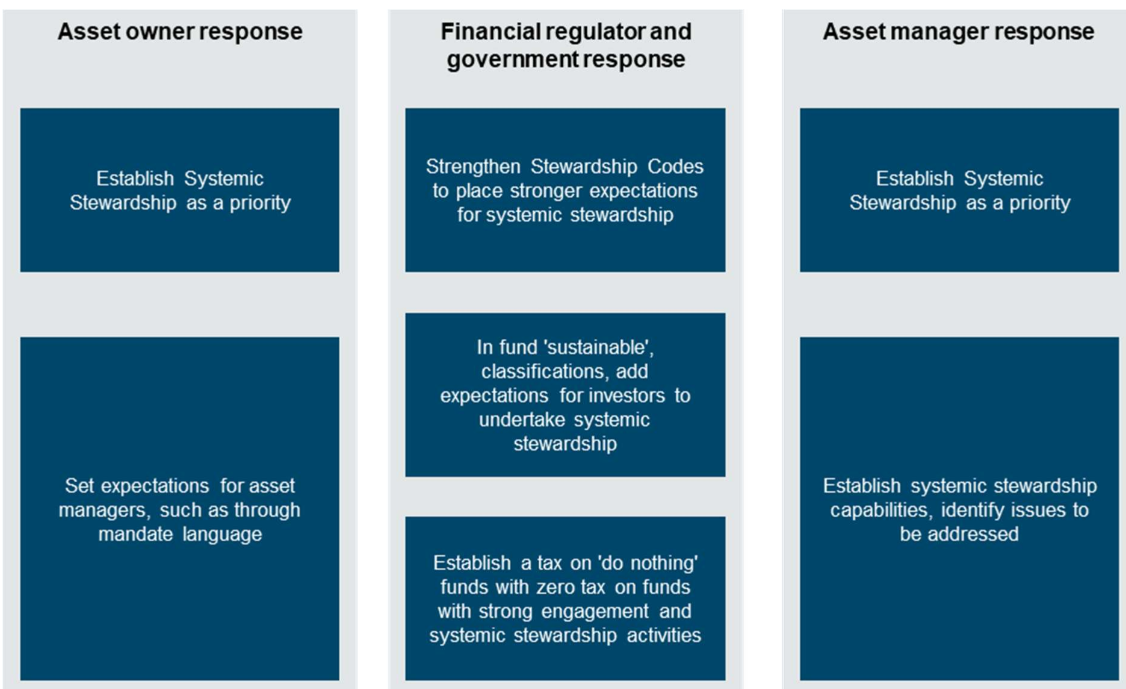
However, despite the growing investor engagement, the investment community is far from doing all that it can to address key systemic challenges. A fundamental problem is free-riding.

"*If the entire market were a portfolio, we should be focused on how to improve the Sharpe ratio of the market as a whole, over time, not just on how to extract the best possible return from it as it stands today*."[32]

"System-level investors think beyond "What are the carbon emissions and working-condition consequences of our investment in this enterprise or fund?" and instead ask "What can we do, as an individual investor and as a collective investment community, to address climate change and labor issues and, in turn, help to foster an environment and society that promotes the long-term growth and solvency of our assets?". They do so not at the expense of long-term investment prospects

Figure 6 outlines our recommendations as to what might assist in delivering on both a stronger quantity and quality of system stewardship. It naturally calls on multiple stakeholders from asset owners, asset managers and regulators. At the centre of these efforts is the need for stronger Stewardship codes and the requirement that sustainability funds require more proactive engagement.

FIGURE 6: RECOMMENDATIONS FOR STRONGER QUANTITY AND QUALITY OF INVESTOR SYSTEMIC STEWARDSHIP



Source: DWS Investment GmbH (June 2022)

[32] The Investment Integration Project (TIIP) 2022 https://www.tiiproject.com/system-level-investing/

4 / Conclusion: The increasing importance of "S" and "G" for global investors

The Russian invasion of Ukraine has propelled the issues of "S" and "G" into the forefront of investors' minds. From a social perspective, the invasion breaches international law and is an abuse on human rights. From a governance perspective, it reveals what has been known for some time of the strong links that exist between Russia's so-called private and the public sector and the underlying risks these pose, for example in terms of facilitating corruption and promoting crony capitalism.

The COVID-19 pandemic had already lifted the visibility of social issues, such as paying a decent wage, providing a safe working environment and dealing with suppliers fairly, into what investors should consider as financially material. The Russian invasion has now extended this focus at a company level to the operations of the state and her agents. We expect it may trigger a change in investor mindsets whereby the benefit of doubt or look the other way will be replaced by a greater examination of the role investments play in terms of social and governance outcomes.

We have already started to see a number of western companies taking action to end their involvement with Russian entities. The main headlines began with the international oil majors, a U.S. airline ended its code share agreement with the Russian national carrier and western mail delivery operations cancelling deliveries into Russia. This decoupling of western company engagement has continued. Indeed, any company with operations or interactions with Russia will be scrutinized particularly if that company wishes to uphold any ESG or sustainability credentials it might have or wish to hold on to.

The invasion will also have implications for European policymakers currently defining a new social taxonomy. As part of the EU's social taxonomy, the Commission is classifying activities which contribute positively to society, those that do no significant harm and those that are harmful. In its draft presented last year, the defense and weapons industry joined the gambling and tobacco industries as being harmful and so potentially not socially sustainable. While opposition has appeared in the development of a social taxonomy at an EU level has appeared[33], we expect the debate on the defense and weapons industry could change after the Russian invasion of Ukraine and specifically that western-based weapons' manufacturers may be viewed less as agents of war and more a guarantor of a country's right for self-determination.

The PRI, in its statement to its signatories, stated[34] that the Russian invasion of Ukraine is a global human rights issues and poses a serious threat to our rules-based international order. This in turn will impact the protection and promotion of human rights and increase long-term environmental, social and economic risks. The PRI is therefore examining, among other things, the ESG implications for example relating to the energy transition, business and human rights through the lens of the UN Guiding Principles and the functioning of international institutions.

This means investors will likely be mobilized to support open and democratic societies, which typically have lower levels of corruption, better working conditions and are better at managing natural disasters. One area of investment interest could therefore relate to sovereign bond funds that screen according to whether a country safeguards and enhances the political civil rights of its citizens. The development of SDG-focused sovereign bond funds could therefore bring investors into a more active role in promoting peaceful societies and building strong institutions, which aligns with SDG16 (peace, justice and strong institutions). Sovereign bond investors could then become more vocal in engaging Finance Ministries to support national SDG strategies.

[33] City A.M. (February 16, 2022). The EU's plans for a "social sustainability" taxonomy are a dangerous intervention

[34] PRI (March 2, 2022). Russian invasion of Ukraine https://www.unpri.org/news-and-press/russian-invasion-of-ukraine/9587.article

IMPORTANT INFORMATION – EMEA, APAC & LATAM

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