

Fifty shades of grey: investing in arms and defence

‘Geopolitical tensions fuel Dutch defence industry’, NOS reported on 28 May 2024. Many institutional investors typically excluded arms manufacturers in their sustainability policies. Has that changed since the moment aggressor Russia invaded Ukraine in early 2022? Investing in arms and/or the defence sector has always been a sensitive issue. And raises moral questions and emotions. In this article, we explain the dilemmas in the thought process. Spoiler alert: this is not a black-and-white story, but an article with a wide range of shades of grey. Should pension funds invest in arms and/or defence or not? And will defence fall under the S of ESG? With a useful list of concerns at the end of this article.

What do you think? We look forward to receiving your response. Mail your opinion to marketingnl@cardano.com. The response will be treated confidentially.

Experts



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Investing in weapons and/or defence is controversial for many investors. Of course, investments in controversial weapons or ammunition are out of the question. Weapons or munitions that have a disproportionate and indiscriminate impact on civilian populations: nuclear weapons, anti-personnel mines, biological weapons, chemical weapons, cluster munitions and white phosphorus weapons. Producing, selling or distributing these has been prohibited by law in the Netherlands since 2013. Financial companies based in the Netherlands have been prohibited since 2013 from investing in companies that produce, sell or distribute cluster munitions, or crucial components thereof. So much for controversial weapons. Remains: conventional weapons. And this is where the dilemmas immediately begin.

Application of the 'dual use' criterion

Therefore, first some definitions. Most companies are not just engaged in the production of weapons or ammunition. Many are large 'dual use' companies that make both civilian and military products. Crucial here is whether application is possible in different ways. Is the application of a product, service or technology linked to a controversial product? The 'classic' example is General Electric, the giant in power generation, aircraft engines and medical equipment and where 3%-5% of sales come from products with military applications.

For example, pension fund ABP invests in GE because the company is not involved in the production of controversial weapons and because defence personnel are compulsorily affiliated to the pension fund for government employees (ABP - Algemeen Burgerlijk PensioenFonds). To clarify, ABP's investment policy prescribes investing only in companies that act in line with UN provisions. In the Netherlands, regulator AFM actively monitors what can and cannot be invested in. As an institutional investor, you need to ask yourself the question: what do I do with companies that make both conventional weapons and controversial weapons? What do I do with companies that provide software as a defence tool? Or companies that do not make weapons themselves, but produce (essential) components?



Right or wrong: investing in weapons and/or defence?

Which brings us to the central questions of this article: is it right or wrong to invest in weapons and/or defence? And should institutional investors contribute to strengthening national security by investing in arms and/or the defence sector?

Since the start of the war in Ukraine, the Dutch government has been calling on pension funds to invest more in weapons. However, there is hardly any increase in pension funds' investments in arms manufacturers, BNR's February 2024 survey showed. With this, the pension funds are ignoring the wishes of national politicians. They are badly needed to increase defence production capacity, according to outgoing minister Ollongren.

The Russian invasion of Ukraine had a direct impact on the defence budget in many countries. Global military spending reached a new record in 2023 for the ninth year in a row. The Stockholm International Peace Research Institute (SIPRI) reported a 6.8% increase in spending that year, to more than 2,290 billion. In Europe, defence spending rose 13% in 2022.

Government largest customer of defence

The survey shows that the total turnover of NLDTIB companies related to defence and security in the Netherlands rose sharply: from €4.7 billion in 2021 to €7.7 billion in 2023, an increase of 62%. The share of defence- and security-related turnover in the total turnover of companies is also increasing. The NLDTIB is the Dutch Security and Technology Industry Foundation. The sector is knowledge-intensive and thus important for the Dutch economy.

There are producers of defence equipment, shipyards that build submarines and naval vessels in addition to civilian vessels, aircraft manufacturers that also produce weapons and there are producers of space technology with military applications. And there are thousands of suppliers in the chain that make specialised parts for large arms companies, but also non-military products. And at a Dutch company like TNO, a lot of military research is done. But there are also cyber security providers that protect governments, companies, public organisations and civilians from attacks by criminal groups and countries like Russia, North Korea and Iran. Often, the Dutch armed forces (the government) is the biggest customer of these companies.

Exclusion

So much for producers. Further down the value chain we find US supermarket chain Walmart, which has sold handguns and ammunition for military assault weapons for years. After several 'school shootings' in the United States, this prompted Cardano, then ACTIAM, to exclude producers and sellers of small arms. This happened before other Dutch investors did so. Incidentally, a number of other Dutch pension funds already exited Walmart in 2013, because they thought the working conditions were too bad and the Walmart board was not open to dialogue with shareholders.

Investing in autonomous drones...?

This brings us to applying the exclusion approach within ESG policy. Every pension fund naturally applies its own ESG criteria. But what about investing in new cybersecurity solution providers now that DDoS attacks, ransomware attacks and data theft are a serious and real danger? And what about autonomous, armed drones? Autonomous weapons decide life or death without human intervention. These drones are not considered prohibited weapons, but in an armed conflict, their deployment must meet all the requirements (discrimination and proportionality) set by international law.

The Rutte II cabinet wrote in a parliamentary letter in 2016 that autonomous offensive weapons are part of a 'permanently technologically advanced Dutch armed forces'. In other words, defence companies often invest heavily in R&D to create advanced technology and products. With this focus on innovation, these technological advantages can also be used for civilian purposes. This sounds logical because the government has the monopoly on violence (so-called sword law); one of the foundations of the democratic rule of law. The military, police, courts and prosecutors are allowed to use forms of force to enforce laws and regulations. Moreover, NATO allies have agreed to commit to the so-called NATO norm of 2% of GNP (Gross National Product) that would be needed to defend the NATO treaty area.

Will 'war bonds' return in 2024?

By the way, governments can issue government bonds themselves ('defence bonds') in which pension funds and other institutional investors can invest. One of the first war bonds ('war bonds') were issued by the United States during the War of 1812. This earned Congress the then gargantuan sum of \$11 million used to finance the war.

Fast forward to 2024. In a diplomatic letter from the French government (14 March 2024) to various foreign ministries in Europe, France stated that 'the EU must make up for decades of under-investment in its defence and its defence industry.' 'There are several avenues worth exploring, individually or combined to each other.' One of the suggestions in the letter was to establish 'war bonds'; something that Germany, the Netherlands and the Nordic countries opposed.

What is wise for pension funds?

What should institutional investors do? Do they prefer to be doves of peace or opt for Realpolitik? When geopolitical tensions increase, investing in defence stocks can be very attractive financially. But like all pension fund investments, these investments must also meet certain conditions. Some pension funds cite their ESG policy as a reason not to invest more in defence. Wrongly so, stated Admiral Rob Bauer, NATO's top military officer, in early March 2024. He therefore expects defence to come under the S (Social) of ESG.

'As long as it doesn't supply regimes that violate human rights' is a common and understandable fear among pension funds. And that while nine of the 10 largest Dutch pension funds invest in arms manufacturers that supply systems to countries that violate human rights. So says a survey by peace organisation PAX's Eerlijke Pensioenwijzer (Fair Pension Guide) on pension fund investments in 2019. More updated data is not known. With that, PAX argued that pension money still ends up with arms companies that keep Saudi Arabia's fighter planes in the air, according to the PAX research; 'planes used in bombings that cause many civilian casualties in Yemen. This argues in favour of issuing government-issued 'defence bonds', where bondholders have guarantees that their investment will not be used for such purposes.

Considerations when investing in arms and/or defence

- As a pension fund manager, what do you and your pension members think? Facilitate the discussion.
- Recognise the importance of correct definitions (weapons, defence, dual use, cyber technology).
- Know the difference between conventional and controversial weapons.
- What principles underpin the pension fund's investment policy and why?
- Is there room in the investment policy to invest in weapons and/or defence sector? Why or why not?
- Do you distinguish between companies in different stages of the supply chain (producer - seller - maintenance - resale, etc.).
- Do you have knowledge of the existence of new (autonomous) weapons, such as drones, where dual use also plays a major role?

Conclusion

Wars and armed conflicts will always exist, with weapons being used either as a means of attack or defence. An institutional investor can choose to be part of this directly or indirectly. Supporters will say that weapons serve to defend freedom and democracy. Opponents see weapons as a threat to peace and stability. The more weapons, the greater the risk of a conflict escalating. Yet peace organisation PAX argues that national defence allows investment in weapons factories. Cardano is in dialogue with PAX on this important and multifaceted issue and regularly reports on these ongoing discussions. More information on our policy around weapons, can be found in our Sustainability Policy under [Sustainable Investment Framework](#).

What do you think?

An investment portfolio with or without weapons? The answer to this is not black and white, but lies in a grey area. And that's not because as Cardano we don't have our own opinion. On the contrary. Rather, we face the complexity of the issue head-on and recognise its many angles and 'shades of grey'. What do you think? We look forward to receiving your response. Mail your question or opinion to marketingnl@cardano.com. Responses will be treated confidentially.

Sources

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