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Abstract

I examine the extent to which temporal shifts in the salience of geopolitical risks may impact investor portfolio choice with a specific focus on sustainable investing. Specifically, I seek to bridge research on issue salience, geopolitical risk, and the burgeoning but rapidly growing literature on sustainable investing. Indeed, casual observations support the view that geopolitical shocks, such as the ongoing Russia-Ukraine conflict, not only reveal flaws in sustainable investing but also most likely significantly weaken the argument of genuine salience of sustainability issues in investor portfolio choices.

Keywords: portfolio choice, responsible investing, geopolitical risks, issue salience.

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The fragile rise of responsible investing

Estimations of the Berlin-based Mercator Research Institute on Global Commons and Climate Change (MCC) suggest that the atmosphere can absorb no more than 1,060 gigatonnes (Gt) of CO_2 if the objective of policymakers is to stay below the 2°C threshold. If true, keeping current emissions of CO_2 at a constant level, the available global carbon budget would be exhausted in about 25 years[1], making it clear how urgently concerned decision-makers need to take action. Notwithstanding that undoubted urgency and the fact that over 80% of the CO_2 emissions can be associated with industrial pollution, so far there have been few incentives for corporations to internalize the social costs associated with the impact on the natural environment (Basse Mama & Mandaroux, 2022). This manifest inaction has prompted most countries to establish a number of schemes meant to curtail corporate greenhouse gas emissions. However, countries differ considerably in how (successfully) they tackle this climate change challenge (e.g., Koch & Basse Mama, 2019).

Given half-hearted commitments of major global emitters of greenhouse gases (especially the United States and China) to curb emissions as well as corporate procrastination, it appears that the burden of fighting against the degradation of the natural environment eventually rests on daily decisions of environmentally-conscious citizens and corporations (Shive & Forster, 2020). In this vein, the last two decades have been characterized by a steadily growing public awareness of climate change and potential adverse effects of greenhouse gas emissions on, for eample, cognitive functioning, the hazard of deadly diseases, or risk aversion. As a result of both the growing awareness and the various environmental regulations underway, investors not only increasingly require that environmental, social and governance (ESG) factors are incorporated in investment and security analysis (Amel-Zadeh & Serafeim, 2018), but they also influence their investee firms' ESG choices (e.g. Dyck et al., 2019). However, critical observers contend that over time, the ESG movement has "transitioned from doing good to doing well and from plow-minded investors to banner-minded and pseudo-ESG investors" (Statman, 2020, p. 16).

Regardless of whether or not investors are using the label of sustainable investing as a fig leaf, a question of paramount interest is whether we would be right to assume that the level of salience of environmental issues in investor portfolio choice is constant over time. To address this question, we start by relying on a few empirical accounts.

Research shows that the financial value of firm-level social and environmental responsibility has substantially increased following the 2008/2009 global financial crisis. As would be expected, financially motivated investors have started asking their investee firms for more environmental and social activities following the financial crisis (Dyck et al., 2019). Similarly, exploiting the 2008/2009 global financial crisis as an exogenous shock to the salience of corporate sustainability, Basse Mama and Fouquau (2022) find that the marginal investor would assign far too low a market valuation to corporate environmental

[1] https://www.mcc-berlin.net/fileadmin/data/clock/carbon_clock.htm (Accessed 1 June 2022). The same source estimates that, in the scenario of 1.5°C, the global carbon budget would be exhausted in even less than 8 years from now.

innovation in the period up to 2007 compared to the valuation attached to corporate environmental innovation post-shock. That is, the financial crisis may well have sharpened awareness on ethics and the degradation of the environment in the financial industry.

I build on the foundations of institutional theory to assess the extent to which and how abrupt a shock to the sixteenth social development goal of the United Nations (UN SDG 16), in casu the Russia-Ukraine conflict, might have affected the propensity of institutional investors to make investment decisions in accordance with the principles for responsible investment.[2] Institutional theory posits that when confronted with demands from heterogeneous stakeholder groups that are far too incompatible, real decision makers (e.g., corporations, governments, and investors) will respond to these external pressures based on perceived issue salience (Bundy et al., 2013). This in turn depends on the perceived urgency and legitimacy of the issue at hand. In any case, if, when, and the degree to which real decision makers will respond to stakeholder pressures, hinge upon the perceived costs of benefits of mobilizing and committing resources (Durand et al., 2019).

Shaky salience of sustainability issues in the financial market amid geopolitical shocks

Clearly, the current geopolitical context shifts public and investor attention towards the political and economic developments of countries in which the firms operate, yet investors care to a larger extent about potential reputational risks arising from their investments in companies that operate in/with the countries in conflict. As a result of restrictive sanctions against Russia from the United States and the European Union (EU), there has been a generalized surge in the political risk exposure of firms that operate in an international setting. It thus comes as no surprise that the Russian military aggression against Ukraine makes continued engagement of corporations in Russia a source of looming reputational risks. However, seen through the prism of Western corporate withdrawal from South Africa in the 1980s, the current seemingly 'voluntary' withdrawal of a number of corporations from Russia[3] can hardly be viewed solely from the angle of the willingness of the respective firms to promote peace. Actually, we have been witnessing a radical shift in sentiment in the EU on defense spending, with, for example, Germany planning to massively increase military spending by €100 billion. At the same time, some governments in Europe (e.g., Germany and the United Kingdom) are planning to diversify the portfolio of their energy suppliers moving steadily away from Russia toward such countries as Qatar, Saudi Arabia, Iran, and Venezuela (all countries whose records on human rights and social issues are poor). In Germany, the change in the diversification strategy even includes (1) mulling over an extension in the lifetime of the last three nuclear remaining power plants that were initially planned to be phased out by the end of 2022[4], and (2) temporarily increasing the use of domestic coal reserves.

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[2] Please, access the following link to see the six principles: https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment (Accessed 1 June 2022).

[3] https://som.yale.edu/story/2022/almost-1000-companies-have-curtailed-operations-russia-some-remain (Accessed 1 June 2022).

[4] FAZ online: https://www.faz.net/aktuell/wirtschaft/die-gruenen-streiten-ueber-atomkraft-und-energieversorgung-17849568.html (Accessed 5 June 2022).

The severity of the invasion and the extensive press and analyst coverage of the massive destruction with nearly 7 million Ukrainian refugees in just a few months has sparked a sense of urgency, prompting public outcry, reminding the international community of the need to rapidly take appropriate actions.[5] In addition, it should be emphasized that Ukraine is a key global exporter of commodities such as corn, sunflower oil, and wheat. Thus letting the war wipe out a substantial portion of the harvest might lead to pronounced global shortages, higher food prices, and famine especially in the developing world. These aforementioned arguments attest to both the relevance and urgency of the issue at hand. Notwithstanding, firms and investors might not directly draw from this urgency an obligation to act; this will only occur when there is a sort of legitimacy in doing so.

The fly in the ointment in the observed sentiment shift is that, for example, the current German government is a coalition of social-democrats, liberals and Greens. While sustainability-focused investors would typically shun stocks of firms making revenues from weapons or products with a high carbon footprint, the observed historic shift in the sentiment in the EU and the United States about national security allows the question of whether the Russian invasion of Ukraine has rendered investment in stocks of corporations operating in the defense, oil, and gas sector, suddenly socially acceptable even by sustainability-focused investors. The same question applies to making business with countries known to not particularly care about human rights and product responsibility. The EU might have indirectly legitimized increased reliance on natural gas and oil by clearly choosing to include US export of liquefied natural gas (LNG) in their new energy plan, which jeopardizes the objective of the attainment of a carbon-neutral and inclusive economy by 2050. Investors may even draw legitimacy in sustained investments in fossil energy given the revitalization of the sector (in Africa) by governments of developed nations such as Germany and Italy.

As a result, institutional investors have strong incentives to gain, maintain, and defend their legitimacy by responding to the normative pressures arising from the ongoing Russia-Ukraine conflict. If true, I anticipate that even sustainability-focused investors might be tempted to deceptively derive saliency of investing in non-Russian fossil energy stocks, in stocks of weapons and small arms manufacturing corporations. However, there might be cross-sectional variations in the responses by corporations and institutional investors around the globe given that grand societal challenges are in essence "value-laden and socially constructed" (Voegtlin et al., 2022, p. 13).

To the extent that at this time of writing, we only can rely on anecdotal evidence of the (in)ability of the current geopolitical shock to induce a shift in investor portfolio choice, an interesting line of research would relate to addressing this research question within an international setting; the international setting is necessary if putting an end to the Russia-Ukraine were to qualify as a grand societal challenge. An ancillary but related research avenue would be to investigate the determinants of the differential responses of corporations to the heightened normative pressures arising from the conflict. Why should some firms exit, some curtail operations, while some would be continuing operations in countries under embargo? Most importantly, has the conflict revealed the limits of the sustainable finance initiative of the EU? This question is embarrassing as the answer seems to be in the affirmative. Therefore, the EU would need much more energy and effort to convince other players on the salience of sustainability in the financial sector. To

[5] This link provides an overview of the sanctions by the EU: https://ec.europa.eu/info/strategy/priorities-2019-2024/stronger-europe-world/eu-solidarity-ukraine/eu-sanctions-against-russia-following-invasion-ukraine_en (Accessed 2 June 2022).

put it in an intentionally provocative way, the way policymakers have responded to this shock in terms of diversifying energy sources and suppliers shows that ecological sustainability might come well after social sustainability. Is there any primacy left in the ESG-acronym? For the moment, the EU seems only to have focused on the "E", but is this choice warranted?

Conclusion

Geopolitical shocks such as the Russia-Ukraine conflict reveal the shaky foundations of the salience of sustainability issues in the financial industry. Unfortunately, the sustainable finance initiative of the EU relies so heavily on the financial industry (that it makes them?) redirect capital from polluting industries towards those industries meant to be environmentally sustainable. Amid the current conflict, it appears that attainment of such sustainability in the financial industry is much more tedious than assumed so far. An important 'shady' side of the response of major governments to the conflict with its attempts to reduce its dependence on Russian gas (for example, Germany is striving to develop natural gas fields with Senegal) raises the questions of double moral standards: Why develop fossil energy in developing countries when the goal is to increase renewable energy sources at home? To me, such ambiguous signals of the public hand are counter-productive in convincing the financial community about the salience of sustainability in the financial industry.

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