

ESG Spotlight

Exposure to controversial weapons: on the KiwiSaver trail

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Themes:

Controversial weapons, index funds

Sectors:

Multiple

Country:

Global

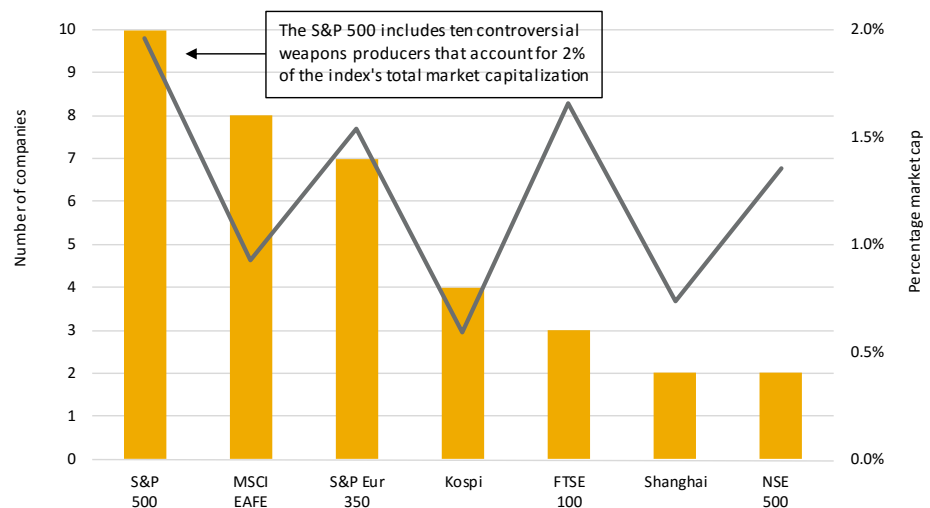
Key Insights

- Recent events in New Zealand demonstrate the reputational and compliance risks that can stem from **active and passive investments in controversial weapons firms**.
- The world's 40 publicly traded **controversial weapons producers are listed on more than 1,000 global equity indices**, a selection of which we analyze in this report.
- Investors can mitigate risks by monitoring relevant legislation and **assessing the extent of their portfolio exposure** to controversial weapons companies.

KiwiSaver puts controversial weapons back on the radar

While many investors have long since recognized that investments in companies that manufacture controversial weapons can generate reputational and compliance challenges, the KiwiSaver case shows that investors can still get caught off guard on the issue of controversial weapons. Public outcry over reports that KiwiSaver, a voluntary investment scheme in New Zealand, had invested upwards of NZD 43.6 m (USD 31.3 m) in controversial weapons firms recently led asset managers working with KiwiSaver to dump 99.9% of their direct equity holdings in these companies. As KiwiSaver providers are now under pressure to exit their indirect (passive) investments in such companies, the case also shows that investors using passive products that track widely followed market benchmarks can face questions about their exposure to controversial weapons companies. In this report, we investigate the KiwiSaver case, segment the world's 40 publicly traded controversial weapons manufacturers by country and identify fresh perspectives on the topic of controversial weapons.¹

Select benchmarks with constituents involved in controversial weapons production



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Some markets have yet to resolve debates around controversial weapons investments

Re-examining controversial weapons investments

Controversial weapons investments are certainly not a new issue, and investors in many markets have developed sophisticated policy stances and portfolio tools to manage the reputational and compliance risks that can stem from investing in controversial weapons manufacturers. However, recent events in New Zealand show that some markets have yet to resolve debates about investing in controversial weapons, and that some investors may face hidden risk exposure through passive investment products, including exchange-traded funds (ETFs) and index funds.

Inquiries into KiwiSaver scratch the surface of controversial weapons exposure

Understanding the KiwiSaver Case

KiwiSaver is a voluntary government-initiated investment plan with 2.6 million members and NZD 33.8 bn (USD 24.2 m) in assets spread across 500 funds managed by 24 private-sector providers.³ Over the past year, New Zealand news agencies have been uncovering the extent to which KiwiSaver providers have been investing in companies involved in the production of controversial weapons, i.e., weapons that cause disproportionate and indiscriminate impacts on civilians, even years after a conflict has ended.⁴

Does purchasing shares on the secondary market constitute investment?

The situation highlights the challenge facing portfolio managers who invest in companies involved in activities prohibited by international treaties that New Zealand has ratified and implemented into national law. As shown below, New Zealand has implemented national laws covering different types of controversial weapons. While the respective laws regarding nuclear weapons and anti-personnel mines ban aiding, abetting, procuring, assisting or encouraging the production of these weapons, the 2009 New Zealand Cluster Munitions Prohibition Act goes a step further by explicitly prohibiting individuals from *knowingly investing* in the development or production of cluster munitions.⁵

International treaties and New Zealand laws pertaining to controversial weapons

Weapon	Treaties and laws
Nuclear weapons	1970 UN Treaty on the Non-Proliferation of Nuclear Weapons
	1987 New Zealand Nuclear Free Zone, Disarmament, and Arms Control Act
Biological weapons	1975 UN Biological Weapons Convention
	1987 New Zealand Nuclear Free Zone, Disarmament, and Arms Control Act
Chemical weapons	1996 Chemical Weapons (Prohibition) Act
	1997 UN Chemical Weapons Convention
Anti-personnel mines	1998 New Zealand Anti-Personnel Mines Prohibition Act
	1999 UN Anti-Personnel Mine Ban Convention
Cluster munitions	2009 New Zealand Cluster Munitions Prohibition Act
	2010 UN Convention on Cluster Munitions

Source: Legal documents⁶

Comparing KiwiSaver and the Super Fund

An important point of comparison in the KiwiSaver debate is the New Zealand Superannuation Fund (Super Fund). Unlike KiwiSaver, the Super Fund is managed by a state entity, Guardians of New Zealand Superannuation, whose mandate includes making commercially prudent investments without undue risks to the Fund, while avoiding prejudice to New Zealand’s reputation.⁷ In accordance with this mandate, the Super Fund maintains an exclusion list banning investments in a group of companies making products that conflict with government policy.⁸

New Zealand news agencies dig into KiwiSaver

Despite concerns about the extent to which the Super Fund does or should screen against companies involved in banned activities,⁹ its exclusion list has become a de facto normative standard for evaluating other New Zealand Crown Financial Institutions and KiwiSaver. In August 2015, the *Sunday Star-Times* published a story describing how two KiwiSaver providers invested in funds exposed to at least three companies excluded by the Super Fund for their involvement in manufacturing cluster munitions and anti-personnel mines.¹⁰ A year later, in August 2016, *Radio New Zealand (RNZ)* reported that default KiwiSaver providers were investing in companies making these weapons.¹¹ The *New Zealand Herald* then revealed an analysis of about 500 KiwiSaver funds, finding that about 2 million people were unwittingly investing upwards of NZD 152 m (USD 108.8 m) in companies blacklisted by the Super Fund.¹²

The KiwiSaver story caused a wave of reactions from the public, government, law-enforcement and fund managers

The KiwiSaver story was followed by public outcry,¹³ government inquiries,¹⁴ a complaint filed by Amnesty International,¹⁵ and an assessment by the police and the New Zealand Financial Markets Authority.¹⁶ While the police did not find evidence of an offense,¹⁷ KiwiSaver providers ultimately committed to sell 99.9% of their actively managed shares of the controversial weapons companies in question.¹⁸ While the dust appears to have settled with respect to direct KiwiSaver holdings, concerns about index funds linger.¹⁹

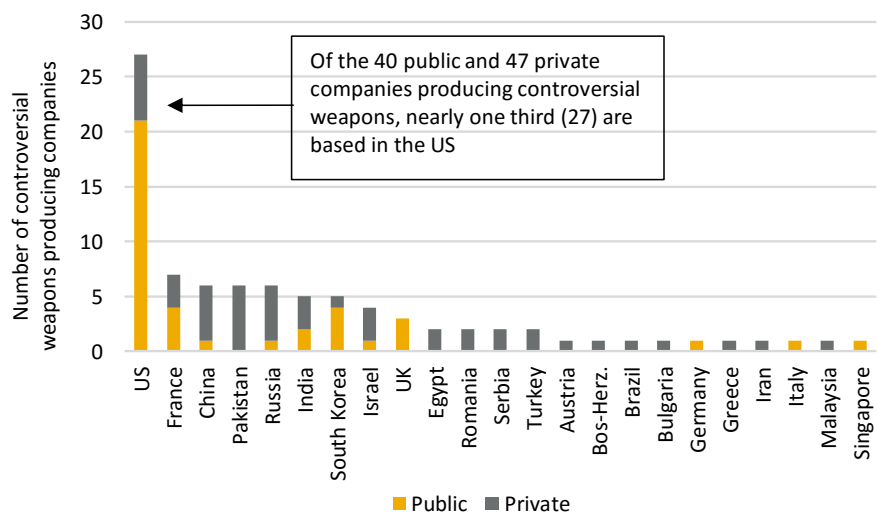
Applying lessons from the KiwiSaver case

Importance of portfolio analysis

Investors can manage risks by understanding local norms and regulations, and monitoring portfolio exposures

The KiwiSaver case illustrates that investors can still be caught off guard by controversial weapons investments despite the widespread policy development that has occurred on this issue over the past ten years, particularly in Europe. For investors based in countries that have ratified international treaties²⁰ or implemented national laws to ban controversial weapons production, or for those with a multi-jurisdictional footprint, this situation reinforces the importance of understanding local norms and regulations, and monitoring portfolio exposure to controversial weapons firms.

Number of companies producing controversial weapons by country



Source: Sustainalytics²¹

Our country analysis shows where private and public controversial weapons companies operate

Controversial weapon companies by country

According to Sustainalytics’ Controversial Weapons Radar, which provides a framework and regularly updated research that investors can use to identify companies involved in controversial weapons, 87 companies operating across the globe (40 public and 47 private) are directly involved in the production of these weapons.²² As shown in the chart above on p. 3, more than half of the world’s public companies producing controversial weapons are based in the US.

Major benchmarks can expose investors to controversial weapons companies

The role of passive funds

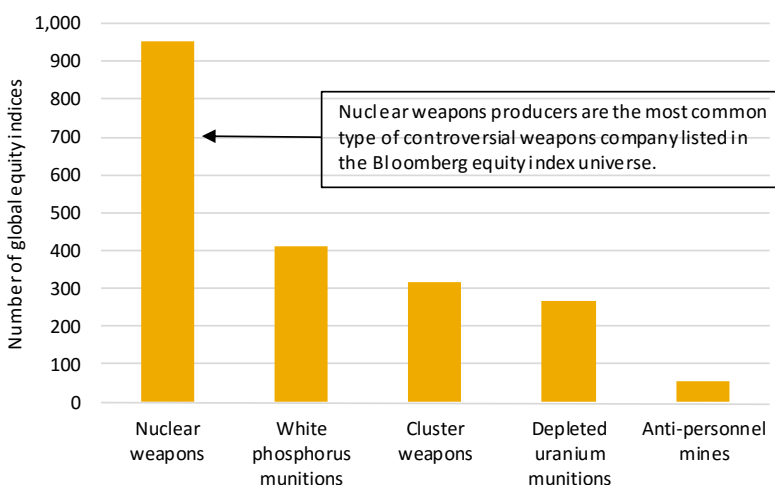
The KiwiSaver case also shows that investors offering passive investment products can face questions about their exposure to controversial weapons companies. This development is notable, as most national debates on controversial weapons investments have centred on investors’ direct equity holdings. While some laws prohibiting controversial weapons investments provide exceptions for index-based products,²³ the KiwiSaver case calls attention to the fact that major equity benchmarks do not typically consider companies’ business activities and that some unitholders of ETFs and index funds that track major indices may object to their (indirect) exposure to controversial weapons companies. Given the current market shift towards passive management – global assets under management (AUM) in passive strategies grew 230% from 2007-2016 compared to just 54% for those with active strategies²⁴ – the scope for such questions may expand.

Many broad equity indices contain controversial weapons companies

Index representation by controversial weapon type

The figure below shows the number of equity indices that include shares of the world’s 40 publicly traded controversial weapons producers. This analysis provides insight into the relative size of different weapons types. Nuclear weapons producers show up on nearly 1,000 global indexes, compared to less than 100 for anti-personnel mine manufacturers. The prevalence of nuclear weapons companies is partly due to the relatively large number (30) of publicly traded nuclear weapons companies and the legality of nuclear weapons production in nuclear states.²⁵

Number of equity indices by controversial weapon type



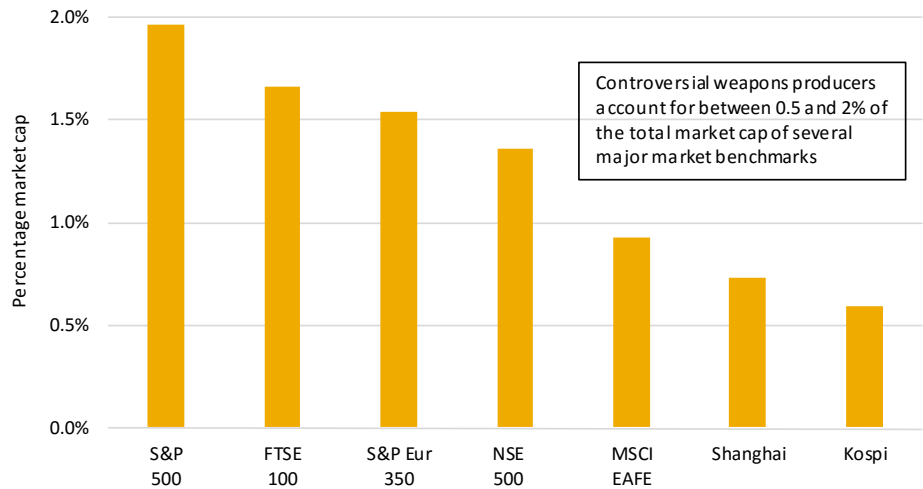
Source: Sustainalytics²⁶

Controversial weapons producers account for almost 2% of the S&P 500

Representation on major benchmarks

The chart below indicates that publicly traded controversial weapons producers account for between 0.5% and 2% of the total market cap of some of the world’s most important benchmarks, such as S&P 500 (1.9%), FTSE 100 (1.7%) and MSCI EAFE (0.9%). These percentages are marginal, but many passive investors may be unaware that these indices offer *any* exposure to controversial weapons. While ethical and environmental, social and governance (ESG) indices have multiplied in recent years, established market benchmarks account for a significantly larger share of the USD 6 trn in passive AUM.²⁷

Market capitalization of controversial weapons producers on selected market indices



Source: Sustainalytics²⁸

Investors can still be caught off guard by controversial weapons investments

Perspectives on the path ahead

The KiwiSaver case demonstrates the reputational and compliance risks that can stem from investments in controversial weapons companies. Many investors are highly attuned to such challenges and have developed policies and tools to mitigate these risks, either voluntarily or as a means to comply with national legislation. The KiwiSaver case illustrates how investors can still be caught off guard by controversial weapons issues and that some markets have yet to undergo a full debate about controversial weapons investments.

Passive investors can also face questions about controversial weapons companies

The KiwiSaver example is also notable in that it shows that investors using passive products can face questions about their indirect exposure to controversial weapons firms. In markets where relevant legislation does not set specific guidelines around index-based products, investors using passive products, including those that track major market benchmarks, could face unexpected public and regulatory scrutiny. Whether dominant market benchmarks should incorporate ESG criteria is certainly not a new question, but the KiwiSaver case may raise awareness about some of the limitations of a pure market cap-based approach. Some large investors have argued that mainstream benchmarks should incorporate material ESG factors.²⁹ We expect this debate to advance in the years ahead as ESG integration proliferates.

Endnotes

- 1 There is no universal definition of controversial weapons. We define controversial weapons as weapons that cause disproportionate and indiscriminate impacts on civilians, even years after a conflict has ended. For the purposes of this report we include the following weapons in our analysis: anti-personnel mines, biological and chemical weapons, cluster weapons, depleted uranium ammunition, nuclear weapons and white phosphorus weapons.
- 2 Sustainalytics (2016), data collected from Sustainalytics Controversial Weapons Radar, Bloomberg, and exchange-traded funds that track market indices.
- 3 KiwiSaver, government website, last accessed (29.09.2016) at: <http://www.kiwisaver.govt.nz/new/>.
- 4 Sustainalytics Controversial Weapons Research, last accessed (10.25.2016) at: <http://www.sustainalytics.com/controversial-weapons-research>
- 5 New Zealand Cluster Munitions Prohibition Act (2009), last accessed (29.09.2016) at: <http://www.legislation.govt.nz/act/public/2009/0068/latest/DLM2171615.html>.
- 6 United Nations Treaty on the Non-Proliferation of Nuclear Weapons (1970), last accessed (17.10.2016) at: <https://www.un.org/disarmament/wmd/nuclear/npt/>; The Biological Weapons Convention (1975), last accessed (01.11.2016) at: <https://www.un.org/disarmament/wmd/bio/>; New Zealand Nuclear Free Zone, Disarmament, and Arms Control Act (1987), last accessed (17.10.2016) at: <http://www.legislation.govt.nz/act/public/1987/0086/latest/DLM115116.html>; Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on their Destruction (19, last accessed (10.10.2016) at: <https://www.opcw.org/chemical-weapons-convention/>; New Zealand Chemical Weapons (Prohibition) Act (5.08.1996), last accessed (18.10.2016) at: <http://www.legislation.govt.nz/act/public/1996/0037/latest/DLM386864.html>; New Zealand Anti-Personnel Mines Prohibition Act (1998), last accessed (17.10.2016) at: <http://www.legislation.govt.nz/act/public/1998/0111/latest/DLM17801.html>; United Nations Convention on the Prohibition of the Use, Stockpiling, Production and Transfer of Anti-Personnel Mines and on their Destruction (1998), last accessed (17.10.2016) at: <http://legal.un.org/avl/ha/cpusptam/cpusptam.html>; United Nations Convention on Cluster Munitions (2008), last accessed (29.09.2016) at: [http://www.unog.ch/80256EE600585943/\(httpPages\)/F27A2B84309E0C5AC12574F70036F176?OpenDocument](http://www.unog.ch/80256EE600585943/(httpPages)/F27A2B84309E0C5AC12574F70036F176?OpenDocument). National laws: <http://www.legislation.govt.nz/act/public/1996/0037/latest/DLM386864.html>; New Zealand Cluster Munitions Prohibition Act (2009), op. cit.
- 7 New Zealand Superannuation and Retirement Income Act (2001), last accessed (25.10.2016) at: http://www.legislation.govt.nz/act/public/2001/0084/latest/DLM113924.html?search=ta_act_N_ac%40ainf%40anif_an%40bn%40rn_200_a&p=1
- 8 New Zealand Super Fund Exclusion List, government website, last accessed (21.10.2016) at: <https://www.nzsuperfund.co.nz/how-we-invest-responsible-investment/exclusions>.
- 9 As early as 2007, reports indicated that the Super Fund had invested at least NZD 230 m (USD 164.7 m) in such stocks, and other concerns about Super Fund investments have resurfaced in recent years. Nippert, M. (02.17.2017), "Dirty Dollars," New Zealand Listener, last accessed (06.10.2016) at: <http://www.listener.co.nz/uncategorized/dirty-dollars/>; Kilgallon, T. and Kilgallon, S. (03.08.2014), "NZ Super Fund Has Deadly Portfolio," Sunday Star-Times, last accessed (06.10.2016) at: <http://www.stuff.co.nz/business/money/10341818/NZ-Super-Fund-has-deadly-portfolio>.
- 10 Rob Stock (18.10.2016), "KiwiSaver, Cluster Bombs, Mines and Nukes," Sunday Star-Times, last accessed (18.10.2016) at: <http://www.stuff.co.nz/business/71324537/kiwisaver-cluster-bombs-mines-and-nukes>.
- 11 Bradley, A. (18.09.2016) "KiwiSavers Fund Cluster Bombs, Land Mines," Radio New Zealand, last accessed (18.10.2016) at: <http://www.radionz.co.nz/news/national/311225/kiwisavers-fund-cluster-bombs,-land-mines>.
- 12 Nippert, M. and Tutty, C. (17.08.2016) "Dirty secrets of your KiwiSaver," New Zealand Herald, last accessed (18.10.2016) at: <http://insights.nzherald.co.nz/article/kiwisaver-investments>; Others have also raised concerns about KiwiSaver funds containing sovereign bonds of countries that develop, use, or stockpile controversial weapons: Stock, R. (28.08.2019), "Human rights and KiwiSaver: Death penalty, extrajudicial killings, and repression," Sunday Star-Times, last accessed (28.10.2016) at: <http://www.stuff.co.nz/business/money/83535751/human-rights-and-kiwisaver-death-penalty-extrajudicial-killings-and-repression>.
- 13 Online petition, "Stop KiwiSaver Fund Managers from investing in weapons," last accessed (18.10.2016) at: <https://our.actionstation.org.nz/petitions/ban-kiwisaver-funds-from-investing-in-arms-weapons-and-war>; Radio New Zealand (06.10.2016),

- “Petition seeks to outlaw KiwiSaver weapons investment,” last accessed (21.10.2016) at: <http://www.radionz.co.nz/news/business/315002/petition-seeks-to-outlaw-kiwisaver-weapons-investment>; Scoops Media (18.10.2016), “James Shaw to accept KiwiSaver cluster bomb petition,” last accessed (21.10.2016) at: <http://www.scoop.co.nz/stories/PA1610/S00259/james-shaw-to-accept-kiwisaver-cluster-bomb-petition.htm>.
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- ¹⁵ Baylond, G. (29.09.2016), Complaint regarding Kiwisaver investments in prohibited weapons, Amnesty International, last accessed (21.10.2016) at: <https://www.documentcloud.org/documents/3035492-AI-Kiwisaver-Complaint.html#document/p1>; Nippert, M. (29.10.2016), “Amnesty International files police complaint over KiwiSaver,” New Zealand Herald, last accessed (21.10.2016) at: http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11701471.
- ¹⁶ Police Media Center (08.09.2016), “Police and FMA complete assessment - Kiwisaver / Cluster Munitions Act,” last accessed (21.10.2016) at: <http://www.police.govt.nz/news/release/police-and-fma-complete-assessment-kiwisaver-cluster-munitions-act>; Bradley, A. (15.09.2016), KiwiSaver investment laws ‘unclear’,” Radio New Zealand, last accessed (21.10.2016) at: <http://www.radionz.co.nz/news/political/313353/kiwisaver-investment-laws-'unclear'>
- ¹⁷ Police Media Center (08.09.2016), op. cit.
- ¹⁸ Bradley, A. (18.08.2016), “KiwiSavers invest in cluster bomb, land mine manufacturers,” last accessed (21.10.2016) at: www.radionz.co.nz/news/national/311225/kiwisavers-fund-cluster-bombs,-land-mines.
- ¹⁹ Nippert, M. (13.09.2016), “KiwiSaver Providers Dump \$109m of Weapon and Tobacco Investments.” New Zealand Herald, last accessed (07.10.2016) at: http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11708202.
- ²⁰ United Nations Treaty Collection, last accessed (21.10.2016) at: <https://treaties.un.org/>.
- ²¹ Sustainalytics (2016), op. cit.
- ²² Including companies that are indirectly involved in controversial weapons activities by way of having ownership stakes in controversial weapons producers, the total increases to 111 companies.
- ²³ Bulletin of Acts and Decrees of the Kingdom of the Netherlands (2012), last accessed (20.10.2016) at: <http://www.stopexplosiveinvestments.org/uploads/pdf/ENGELS%20Verbod%20directe%20investeringen%20clustermunitie%20januari%202013.pdf>.
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- ²⁵ The United Nations Treaty on the Non-Proliferation of Nuclear Weapons (1970, op. cit.) permits China, France, Russia, the UK and the US to maintain stockpiles of nuclear weapons.
- ²⁶ Sustainalytics (2016), op. cit. Biological and chemical weapons excluded as there are no publicly traded companies that manufacture these weapons.
- ²⁷ Monney, A. (29.03.2016), op. cit.
- ²⁸ Sustainalytics (2016), op. cit.
- ²⁹ Cripps, P. (26.08.2016), “Benchmark indexes 'should start incorporating ESG factors,” last accessed (22.10.2016) at: <https://www.environmental-finance.com/content/news/benchmark-indexes-should-start-incorporating-esg-factors.html>

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