Amati Global Investors

Finely crafted investments

Investing responsibly in a complex and divided world

Environmental, Social, Governance and Human Rights Statement - Part 1

Investing responsibly in a complex and divided world

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Investing money can seem abstract, but fund managers come to understand that capital allocation doesn't just make a real impact on people's lives, it can determine the fortune of nations. Sometimes this impact is small, sometimes large. Sometimes it is foreseeable, often there are surprises. The stock market is a mechanism for allocating money from all kinds of savers to the most attractive public companies, allowing them to grow and fulfil their potential, whilst at the same time allowing the public to benefit from their success. Its efficiency and transparency is vital to every modern economy and it is one of the key institutions of every democracy. It gains its integrity from effective independent regulation. With this in place it becomes, in an important sense, ethical in its own right, as the regulations hold it to operating in a way attuned to the standards expected by society as a whole, whilst competition then ensures that the best companies flourish.

In his book, *Capitalism and Freedom*, Milton Friedman, drawing on Adam Smith's *Wealth of Nations*, argued that "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud".[1] By choosing to give up profits to achieve a certain social end with no possible commercial benefit, Friedman suggests, a business manager is both imposing a tax on shareholders and deciding how to spend it, functions which belong properly with elected Government in a democracy. Doing this in a public company is, for Friedman, to bring politics into the private sector outside of the boundaries of the political process. "Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest?Is it tolerable that these public functions for taxation, expenditure, and control be exercised by the people who happen at that moment to be in charge of particular enterprises, chosen for those posts by strictly private groups?"[2]

To be clear, Friedman did not argue against companies pursuing a social objective where there is a clear business interest in doing so, as for example, a company cultivating outstanding employment practices in order to attract and retain the best talent, or a mining company operating in a developing economy supporting social projects benefiting the local community in order to cultivate a social licence to operate. This is part of the process of how competitive markets, when allowed to work, serve the interests of society. Whilst there are major failings in Friedman's argument, which are discussed below, we should not lose sight of the core understanding he brings about the social benefit brought by competitive markets operating freely within a legal structure defined by democratic government.

Over the past few years, there has been a proliferation of ideas in the fund management industry based around ideas of social responsibility. Responding to demand from the public, firms have created products with labels to address this demand such as "Responsible", "Sustainable" or "Net Zero". These have largely replaced the older equivalent fund label common in the 1990s, "Ethical". What each of these labels has in common is the idea that simply following the rules of the stock market and operating within the law to optimise returns for investors leaves some kind of ethical deficit, which can be filled by overlaying a set of non-financial criteria.

1. Friedman, *Capitalism and Freedom*, 1962, p.112.

2. Ibid., p. 113.

In doing so investment houses risk taking on a role which, insofar as it results in the profits from a public company being deployed to pursue a social or political objective without having a commercial reason for doing so, belongs to government. They are also inviting consumers to think that investment without this added extra will somehow be irresponsible or unsustainable and that there is nothing which policy making can or should do to change that.[3]

Rapid growth of these special label products and the fear that expectations are being created amongst consumers that might amount to mere window-dressing in practice, has in turn prompted regulators in the UK and Europe to step in to define what should be meant by such terms. Ironically, in doing so the regulator has moved beyond the normal area of government into the role of defining what it means to be "responsible" or "sustainable", concepts which are subjective, over which there should be an ongoing debate amongst market participants. They are words whose definitions should be constantly evolving.

Regulators would argue that they need to intervene in order to protect consumers from "greenwashing", the idea that a fund with a particular label doesn't really make any tangible difference to the ethical or environmental objective it sets out. It could be argued that such labels are always likely to set up false expectations in the mind of the consumer and that therefore their use in general is unwise. Better to explain what asset class you invest in, how your investment process takes account of ESG type risks and what ethical boundaries you set as a manager, if any, over and above the "rules of the game", and make no claims about how much this will contribute to positive change in the world even though you hope and expect that it will. If achieved, positive change will be the result of the whole complex mechanism of human society; of Governments and civil institutions, functioning together as they should. Fund managers shouldn't try to claim any undue credit for this, or that they, rather than Government, can somehow fix an ethical failure in the design of the system itself. The crisis of climate change will only be solved by effective policy making and cooperation by governments across the world. As Tariq Fancy, former CIO for Sustainable Investing at Blackrock, has pointed out, for the finance industry to give the impression that it can substantially solve the problem risks creating a smoke screen which masks a failure in terms of the collective policies of governments, and worse still, cultivates the belief that no further government intervention is required.[4]

There is a fundamental ambiguity which sits at the heart of debates over non-financial analysis such as ESGH (we add an "H" on for Human Rights, believing that this is one of the most important areas for non-financial analysis). Is the intention of the fund manager in conducting this analysis to use it to make better investments, or is it to try to change the behaviour of investee companies into taking non-commercial decisions in line with the fund managers' ethical preferences?

3. There is a completely different discussion to be had here about private companies, which are often controlled by a small group of shareholders who are quite a liberty to decide to deploy the profits of their company for particular social purposes. There are many famous examples of this including the great 19th Century Quaker companies like Cadburys and Clarks. In a private company there can be a unity of purpose amongst the owners as to what social causes they wish to support and this can be baked in to the foundational documents. Such unity of purpose can never be achieved in a public company, where constantly changing shareholders will have different views on what causes they wish to support. Whilst this could be seen as a drawback of public stockmarkets, it is offset by the much greater benefits of giving the public access to investment in a wide range of the best enterprises of the day. A world without stock markets would be one of far greater wealth inequalities, in which capitalism would scarcely be able to function.
4. See Tariq Fancy, "The Secret Diary of a 'Sustainable Investor' ", part 3, "The danger of fairy tales", (2021).

This ambiguity was highlighted when Mark Carney pushed the banking industry to no longer lend to the oil and gas industry based on the increased risk of stranded assets.[5] The idea was presented as requiring banks to conduct further risk analysis to make better loans, but it was presented to the public as a policy to tackle climate change (to which in fact it would make no clear difference). The distinction, however, requires some further elaboration with the added dimension of stewardship. Fund managers need to represent the interests of the owners of their funds as shareholders of the companies in which they invest. Doing so requires active engagement with all aspects of a business, and this in turn is one of the drivers of the need for ESGH analysis as part of the investment process. Over the past decade the requirements of being a signatory to the Stewardship Code in the UK have increased greatly, and Amati has made it a priority to maintain its status as a signatory, believing that active stewardship is a fundamentally important part of our role as investors. To set this in the context of Friedman's argument, this kind of engagement from fund managers as representatives of the underlying owners, is designed to enhance the commercial value and health of the investee companies. It is not trying to impose a non-commercial agenda.

In making his argument, for the sake of polemic Friedman deliberately downplays the extent to which businesses have a commercial interest in behaving in a socially responsible way within their sphere of operations. This is what Amati being a signatory to the Stewardship Code addresses. It signals a clear intent on our part to engage proactively with investee companies and, in representing the owners of our funds, to help them negotiate the complex and difficult strategic decisions that they face, to the best of our abilities. To do this requires, first and foremost, taking the time to understand the business in as much depth as possible. It requires genuine dialogue and trust on both sides. It is very rarely confrontational. It is also important to recognise that the judgements involved here are often ethical ones, operating within the constraints of commercial interests.

Friedman's article on corporate social responsibility has attracted much relevant criticism. In 2020 the online journal ProMarket organised a series of 27 articles to further understanding of the debate in the finance industry. An excellent summary of these was published by Liugi Zingales.[6] Zingales reframes as a theorem what Friedman overstated as a doctrine. He notes that there are three conditions necessary for the theory to hold. First, companies should be both price and rule takers in an environment of true competition. Second, there should be no externalities not addressed by Government through regulation and taxation. Third, contracts are complete, such that all relevant contingencies are specified at no additional cost. Clearly, these conditions are never going to be met. To the extent that they are not met, a space opens up in which ethical judgement is required of both company managers and investors.

Friedman's assumption that simply "staying within the rules of the game" should be enough to guarantee acceptability and decency comes in for particular criticism. Many commentators note that it pays no heed to the extent to which the rules of the game are captured, controlled or sidestepped by large corporations or by much less benign forces, even within a democratic system. Martin Wolf's article for the ProMarket 2020 series takes on this point to suggest that within any given "rules of the game" there will be bad actors who push them to destruction.[7] He sees Freidman's view as "faux naif". "If, as I am arguing, the game is fundamentally political, then the social obligation is to use their power to create a good game, rather than a bad one. What is a good game?" he asks. "Well, here are some things it most definitely is not."

5. See interview 30 Dec 2019 for Radio 4's *Today* programme, summarised by Andrew Sparrow, "Firms must justify investment in fossil fuels, warns Mark Carney", (30 Dec 2019) *The Guradian*.
6. Luigi Zingales, "Friedman's Legacy: From Doctrine to Theorem" (13 October 2020) *ProMarket*.
7. Martin Wolf, "There is a Direct Line from Mitlon Friedman to Donald Trump's Assault on Democracy" (4 October 2020) *ProMarket*.

"It is one in which companies would not promote junk science on climate and the environment; it is one in which companies would not kill hundreds of thousands of people, by promoting addiction to opiates; it is one in which companies would not lobby for tax systems that let them park vast proportions of their profits in tax havens . . ."

Anat Admati's contribution to the debate outlines the view that enforcement of the law is very patchy when it comes to big corporations, whom she calls "too big to jail", whilst Friedman assumes the justice system operates perfectly.[8] She cites a case in California from June 2020 in which PG&E, a utility company with prior safety-related criminal convictions, pleaded guilty to 84 manslaughter charges stemming from a fire in 2018 which destroyed a town and led to dozens of deaths. The company was required to pay $4m in penalties, which is the maximum under Californian law. More famous cases abound, she suggests, from Purdue Pharma, to money laundering at HSBC, Danske Bank and "many others", to DuPont's contamination of drinking water and its cover-up.

The business world of the 21st century is also far more international than that of Friedman's era. Friedman does not begin to contemplate what principles should apply in a country where there is no freedom or political process to start with, and therefore how to deal with companies that operate internationally in both developed and emerging markets, in both democracies and autocracies.

All of these critiques suggest the areas where Amati's ESGH analysis is required to go well beyond Friedman's framework of thinking, specifically to steer away from areas where the "rules of the game" are resulting in terrible consequences. This involves us in making value judgements about legal and political deficits on behalf of investors, something fund managers should do with great caution. In doing so, we adopt the following set of five principles.

1) Resist financialisation
We believe that the ethics of finance are improved as the underlying investors' knowledge of and understanding of what they are investing in improves, and that financialisation (the process where investments are abstracted into mere numbers or indices) works directly against this.

2) Fund manager led process
We believe that the evaluation of ESGH factors and the engagement on them with executives at investee companies needs to be done by the fund managers making the decision on investments, supported by, but not outsourced to specialists.

3) Maintain independent judgement
We believe that active fund managers should preserve independence of thought, whilst engaging critically with broad debates that arise on these topics within the industry and being willing to change our minds if the evidence changes, or if stronger arguments emerge.

4) Be wary of overstatement
Fund managers who overstate the impact that their work can have on specific non-financial goals will create unrealistic expectations, and these may be damaging in their own right. If by giving the impression that something substantial is being done where it isn't, they diminish the perceived importance of sound policy making, strong public institutions and international cooperation in solving the big problems we face today.

5) Analyse the unintended consequences
It's amazing how often a well-motivated policy intention achieves the exact opposite when applied in the real world. One way to help avoid this in ESG thinking is to ask this question: if everyone in the market were to adopt the same approach, would the adverse consequences outweigh the possible benefits?

8. Anat Admati, "Milton Friedman and the Need for Justice", (5 October 2020) *ProMarket*.

Amati's approach to controversial sectors

In terms of sector considerations, there are no sectors in which we are not willing to invest. There was at one stage a view held by 'ethical' funds that the defence, tobacco, gambling and alcohol sectors should be avoided completely. We have always viewed this kind of approach as facile, whilst also recognising that, for the reasons discussed above, in each of these industries the justification of all practices as "following the rules of the game" is not sufficient. In these sectors, as with natural resources, a wide space which requires ethical judgement opens up. In this section we set out the framework we use to make these judgements in relation to three controversial types of business: natural resource companies; defence companies; and businesses which profit from addiction. There are two other topics which we aim to address at a later date: businesses profiting from ultra low-cost supply chains likely to include slave or indentured labour, and high cost credit.

1. Natural Resources

The extraction of natural resources from the earth has been instrumental to human development for at least 3,000 years, since the beginning of the iron age. There are almost no aspects of modern life which are conceivable without such resources being extracted at large scale. They are fundamental. Whilst there are groups of investors who will argue that some or all of the extractive industries should be avoided completely on the grounds that they industrialise the landscape, they are carbon intensive, they can do great harm if run irresponsibly, and safety issues abound, this kind of position is also deeply perverse. It spectacularly fails our Principle 5, the test for unintended consequences, in that if all investors were to adopt this approach, human society as we know it would collapse. If rather only Western countries decided to cease production, then these democracies would quickly become enslaved by the autocratic nations that continue to produce, and on which they would be utterly dependent. (A good example being the ceding of control of the solar industry to the Chinese, where lower environmental standards have allowed them to vastly undercut the companies operating under more responsible standards).

The oil and gas industry in the UK and elsewhere has become something of a political football, often kicked by public figures aiming to harness public concern about climate change with arguments that bear no scrutiny, so poorly conceived that they will almost certainly cause unintended negative consequences for climate change far exceeding the mooted benefits. This has created a situation where public debate is generally of low quality and public opinion often ill-informed. The problems that need to be addressed are profound and complex. The United Nations Framework Convention on Climate Change (UNFCCC), which was born in 1992 and which gave rise to the Earth Summit in Rio that year, the Kyoto Protocol in 1997, the Paris Agreement in 2015, and 28 annual Conferences of the Parties (COPs), has thus far failed to limit the rise of greenhouse gases in the atmosphere or to produce a convincing set of proposals which are likely to do so.But Net Zero declarations and promises abound amongst nations, not so far backed up by much in the way of implementation. This has created a situation where many companies have run ahead of government policy and declared their own Net Zero strategies, and where individual investors (and voters) have also formed views as to what is required. The popular version of this is to argue that we just need more wind and solar power and to stop producing oil and gas. Unfortunately, the first is insufficient, and the second simply makes things worse, because it does nothing to dampen demand, so results in greater imports, likely to be from oppressive or hostile regimes. Russia's invasion of Ukraine, which is both a disaster and a tragedy on every level, serves as a stark reminder of this, funded as it was in large part by exports of oil, gas and derivative products to Europe, whose own production is nowhere near sufficient to meet demand.

Clean Trade

Leif Wenar's book, *Blood Oil: Tyrants, Violence and the Rules that Run the World*, first published in December 2015, gives a detailed account of the workings of the "resources curse", whereby resource-rich states become undermined, and civil society progressively destroyed, by an extraordinary concentration of wealth and power in the hands of a tiny ruling elite who control the revenues from the sale of these resources to other countries. This group of rulers, once entrenched, will resort to extreme violence to quell any opposition, as they have no real need of a domestic economy. In fact, a prosperous business community based on private enterprise would simply represent a threat. Oil is the most notorious commodity in this respect, simply because it became by far the most valuable, and can often be produced offshore, out of sight and out of mind. Wenar also goes on to describe the mechanism of "blowback", whereby the Western nations which have facilitated the rise of such violent resource rich regimes, eventually find that they have empowered their most dangerous adversaries. Russia's actions in Syria and Ukraine, two great stains on the nascent history of the 21st Century, are essentially forms of "blowback". Even beyond its direct human tragedy, war does the greatest possible harm to the environment, so it seems futile to construct policies designed to mitigate climate change which inadvertently result in human rights catastrophes and eventually in blowback confrontations. This in a nutshell is the problem of shutting down Western production of oil and gas in favour of outsourcing the production to resource rich, but oil-cursed states.

In 1948, picking up the pieces after the second world war, the then 58 members of the United Nations passed Resolution 217, the Universal Declaration of Human Rights. In 1966 many of these principles were formulated into the two International Covenants on Human Rights, one for Civil and Political Rights, the other for Economic, Social and Cultural Rights, both becoming legally binding documents now recognised by over 170 states. Article 1(ii) of both of these Covenants states that: "All peoples may, for their own ends, freely dispose of their natural wealth and resources without prejudice to any obligation arising out of international economic cooperation, based on the principle of mutual benefit, and international law." What does this mean? For Wenar it means that there is a baseline for what constitutes the legal exploitation of natural resources: they need to be freely disposed of for the mutual benefit of the people of the nation from whence they come. Wenar conceived of the idea of Clean Trade Acts, to be passed by nations importing natural resources, to set out that certain minimum levels of freedom and governance are required, without which, the resources should be regarded as being stolen.

In 2017 Amati supported the foundation of Clean Trade as a UK-based NGO aiming to promote this principle, and I became a founding director. Amati's funds adopt a Clean Trade approach for any investments in the natural resources sector. The baseline is deliberately set very low, so as not to take the drastic step of completely excluding investments in certain countries without adequate cause. We use the annually updated, and freely available global report from Freedom House, and rule out natural resource investments in countries scoring 15/100 and below. For countries scoring between 15 and 33, which are defined as Not Free, we require a reasonable expectation that three questions can be answered positively: i) does the population of the country have access to the information about the terms under which resources are being extracted? ii) if they don't like the terms, can they protest safely? iii) if they protest, is there a fair chance of being taken notice of?

In reality, investing in countries with very low Freedom House scores is extremely hazardous in any case, so applying this principle is unlikely to cause much conflict with our fiduciary duties as fund managers, but nonetheless, because applying a baseline results in the exclusion of certain investments on principle, we are explicit with our fund investors about this approach. [9]

A striking feature of the global oil industry is that Western-led attempts to limit the flow of oil from or to tyrannical states have broadly failed. For example, UN Resolution 2397, passed in December 2017, aimed to limit North Korean crude oil and refined petroleum product imports to 500,000 barrels per year, amongst other things, in response to the testing of an intercontinental ballistic missile. However, imports continued unabated through organised criminal groups based in Hong Kong, using sea-to-sea transfers and ghost ships, according to an outstanding piece of investigative journalism by RUSI and the FT.[10] Similarly, attempts to impose sanctions on Russian oil exports following their invasion of Ukraine quickly turned into an attempt to impose a price cap on these exports, and even this appears to be failing progressively over time. [11] Once dictators, who organise the entire machinery of state around their own survival, become entrenched, the West has almost no power to reverse the grim political deadlocks which arise. Hence our advocacy of adopting a Clean Trade approach.

Oil and Gas

The world still remains dependent on fossil fuels for more than 80% of its energy requirements. In May 2021, commissioned by the UK Government as chair of COP26 and to great fanfare, the IEA published its view that no new oil and gas developments would be required if the world was to achieve a Net Zero pathway by 2050 because demand would fall.[12] This idea dominated headlines and discussion about the energy sector for the months that followed up to COP26. It quickly morphed into the idea that all new oil and gas developments in the West should be stopped, and UK politicians were grilled about exactly how ruthlessly they would shut down North Sea oil and gas production. Unfortunately the IEA paper itself was dangerously flawed, and the conclusion drawn by UK politicians doubly so. The IEA simply paid no attention to the human rights aspects of oil and gas supply, nor to the geopolitics, serving only to encourage greater dependence of the West on already oil-cursed despotic oil rich states for supply. They explicitly acknowledged that under the pathway they proposed: "For oil, the OPEC share of a much-reduced global oil supply increases from around 37% in recent years to 52% in 2050, a level higher than at any point in the history of oil markets."[13] It shouldn't have taken much in the way of understanding the geopolitics of oil and gas to understand what a disaster this pathway would be likely to cause, but there were remarkably few voices to oppose it. Following Russia's invasion of Ukraine the IEA subsequently revised its view about the need for new oil and gas developments, recognising for the first time that Western dependence on Russian oil and gas would require a fundamental rethink, but did not offer a more penetrating analysis of how not to repeat the mistake.

9. In June 2022 Amati, Clean Trade and King's College London co-hosted an event entitled "Breaking the Link between Oil & Gas and War: Putting Human Rights into ESG." The talks from this event provide more background about Clean Trade and can be viewed on Amati's website.
10. See FT Film, "North Korea and the triads: gangsters, ghost ships and spies".
11. See for example Hinrich Foundation article by Kieran Thompson, "Dark waters: China and India are bidding up Russian oil sales" (30 May 2023) and CNBC article by Sumathi Bala, "Sanctions on Russian crude oil have 'failed completely,' oil analyst says" (3 Feb 2023).
12. IEA, "Net Zero by 2050: A Roadmap for the Global Energy Sector" (2021), see pp. 20-24.
13. Ibid., p. 23.

This conclusion from the IEA's 2022 Energy Outlook Executive Summary provides a much more sensible framework for investors than their 2021 report did:

"Immediate shortfalls in fossil fuel production from Russia will need to be replaced by production elsewhere – even in a world working towards net zero emissions by 2050. The most suitable near-term substitutes are projects with short lead times that bring oil and gas to market quickly, as well as capturing some of the 260 bcm of gas that is wasted each year through flaring and methane leaks to the atmosphere. But lasting solutions to today's crisis lie in reducing fossil fuel demand. Many financial organisations have set goals and plans to scale down investment in fossil fuels. Much more emphasis is needed on goals and plans for scaling up investment in clean energy transitions, and on what governments can do to incentivise this." [14]

Needless to say this revised position of the IEA received no media attention whatsoever in the UK and the IEA's briefly held 2021 position appears to remain the major influence on UK public opinion, albeit a few braver politicians are now daring to challenge it.

Amati's position is that investment in the oil and gas sector remains a strategic necessity where the operations are in Western jurisdictions, for reasons of energy security and in order to reduce the financing of resource-cursed states, and therefore it should be included in our investable universe. But the underlying point in relation to climate change, suggested in passing here by the IEA, is that climate change policy needs to be focused on reducing demand and incentivising the energy transition. Simply reducing local supply of oil and gas, in the absence of reducing demand first, is to court disaster with the kind of energy cost crisis we witnessed in 2022.

The best analysis we have come across of the UK's energy policy (or lack of it) and Net Zero ambitions is in the work of Prof Dieter Helm[15], who has taught many leading UK politicians at Oxford, and who is widely consulted, but apparently rarely listened to by policy makers. He was commissioned by UK Government to write the Cost of Energy Review in 2017, in which he proposed taking steps to break the link between the wholesale electricity price and the gas price, something which would have prevented a good deal of the chaos in the UK electricity market in 2022. He has also proposed the concept of "firm power equivalent pricing" as a way of realistically comparing the cost of renewable energy against baseload power production from fossil fuels. He has pointed out the grave flaw in the UK's Net Zero targets, which is that it ignores the carbon emissions inherent in imported goods, so simply encourages offshoring of emissions. His proposal for reducing demand for fossil fuels is to introduce the "polluter pays" principle via a tax on greenhouse gas emissions more than sufficient to pay for their abatement and a border tax on implicit fossil fuel consumption to avoid simply offshoring emissions. Attempts to introduce such a scheme into Europe were diverted by industry lobbying into a carbon trading mechanism which simply embeds the status quo as a starting point. The tough political debate that should be taking place in respect of achieving Net Zero emissions by 2050 should be around taxing greenhouse gas emissions across the whole economy, rather than the obsession with shutting down North Sea oil and gas production, which will do nothing whatsoever to lower emissions. In selecting which technologies and businesses are likely to be successful in the industrial revolution required to bring about energy transition over the next 30 years, we need sound analysis of the problems and possible solutions, and Dieter Helm's work acts as a much needed reference point on both counts.

14. IEA, "World Energy Outlook 2022", p. 24.

15. See Dieter Helm, *Net Zero: How We Stop Causing Climate Change* (2020).

Mining

To achieve net zero greenhouse gas emissions in the world's major economies will require vast amounts of metal for new infrastructure and replacement power systems. This is the 'green paradox' and investment opportunity, which is that you can't have decarbonisation without mining. However, mining makes its own environmental impact and greenhouse gases are only a small part of this. Because mining tends to be large scale, involves digging deep and moving vast amounts of material through complex industrial processes, some of which use dangerous substances, and at the end of a mine's life, the original environment should be restored, the difference between good and bad practice in this industry is enormous. Because many mining projects are in developing countries, Clean Trade issues are important, and problems surrounding the status of mining licences and Government corruption also abound. In February 2023, for example, Glencore Plc was fined $700m in connection with its guilty plea over a long-standing scheme to bribe foreign officials across many countries, including Nigeria, Brazil, Venezuela, and the DRC, this being only part of expected fines totalling $1.5bn to settle wider bribery and market manipulation accusations.[16] Within the industry, Glencore's reputation for bribery had been well known for many years. These fines don't make up for the harm done. Investment in such companies can't be reconciled with Friedman's idea of companies which operate within the rules of the game. But how do fund managers know which companies operate with corrupt practices? We have to rely on reputation and pay attention to investigative journalism, such as that produced for many years by Global Witness, who published a paper in 2014 about Glencore's corruption.[17]

The ways in which a mining company earns its social licence to operate is crucial. If a company alienates the local community, its project is much more likely to be at risk of disruption or closure. Well run mining companies will not seek simply to meet minimal local environmental and safety standards, but rather to operate according to the highest global standards. The major banks lending to mining projects operate within a strict framework shaped by the International Finance Corporation (IFC), the Equator Principles[18], and may also draw on a large number of other global standards and frameworks which have helped improve industry practice significantly over the last 20 years. How Governments use the royalties and taxes generated from the mines is often more opaque and also requires consideration. It is important that all stakeholders share in the wealth generated from resource extraction. By conducting site visits, speaking with management, keeping an eye on local media sources, and doing detailed analysis, the team at Amati are well placed to make informed judgements.

In order to add further depth to our consideration of non-financial risk factors in this sector, in 2023 we decided to work with Digbee, an ESG disclosure platform dedicated to mining companies. Digbee is a UK-based technology firm, building solutions for the mining industry, with a focus on providing trusted ESG data on mining companies to the investment community, and to other stakeholders. The platform allows mining companies of all sizes to disclose their practices and policies using a set of mining-specific frameworks that align with over 30 global standards. Once submitted to the platform, the data is analysed by an independent third party that assigns a score and delivers a qualitative assessment of ESG risk factors.

16. Reuters, "Glencore sentenced to pay $700 million in US after bribery guilty plea", (28 Feb 2023).
17. Global Witness: "Glencore and the Gatekeeper: How the World's Largest Commodities Trader Made a Friend of Congo's President $67m Richer", (May 2014).
18. See the Equator Principles Association.

Nuclear Energy

In 2013 the Norwegian nuclear physicist, Sunniva Rose, concluded an eloquent TEDx Talk, ending with the question "How is it possible to worry about global warming and not be pro-Nuclear?"[19] We don't see any realistic scenarios for energy transition in which nuclear energy doesn't play a significant role, yet the history of nuclear energy in the UK over the last 30 years has been one of remarkable neglect. Nuclear energy is massively the most energy-dense form of power, and it just so happens that fission doesn't emit greenhouse gases (though like all forms of renewable generation, fossil fuels are burnt in producing the raw materials, manufacturing and construction). In his introduction to the Earthshot Prize in 2021, Prince William noted that a kilogram of hydrogen has three times the energy content of a kilogram of jet fuel. But he failed to mention that a kilogram of hydrogen at atmospheric pressure is over 1,100 litres of gas, whereas the same weight of jet fuel is just over one litre, so the energy density of hydrogen at normal pressure is around 1/330 of jet fuel. Whereas the energy density of nuclear fuel is in the order of 3 million times greater than coal and 2 million time greater than mineral oil on a weight equivalent basis, and much more than this on a litre equivalent basis. [20]

When the first nuclear power plants were built there was already an acknowledgement that this would be the cleanest form of power production. It peaked in 1996 when nuclear energy accounted for around 18% of electricity generation worldwide.[21] The problem was that this was during the Cold War era and nuclear technology for power production was bent to the purpose of providing the raw materials for nuclear weapons, including tritium and plutonium. With the origins of Green Party politics in Europe being in the campaign for nuclear disarmament, it is a bitter irony that the thrust of many environmental campaigns over the past 30 years has been against nuclear energy. The high-profile nuclear disaster at Chernobyl, along with the subsequent accident at Fukishima, has given rise to prevarication and weak policy intent in relation to nuclear energy in the UK, a country which once led the world in nuclear engineering expertise, and in much of the West. As the IEA noted last year: "Although advanced economies have nearly 70% of global nuclear capacity, investment has stalled and the latest projects have run far over budget and behind schedule. As a result, the project pipelines and preferred designs have shifted. Of the 31 reactors that began construction since the beginning of 2017, all but 4 are of Russian or Chinese design." [22]

Proponents of nuclear power argue, correctly in our view, that the energy transition simply can't be achieved at the required scale and speed with solar and wind energy alone, and that in any case, due to their low energy density, these forms of electricity generation require huge quantities of raw materials and energy (derived from fossil fuels in practice) in mining, processing, manufacturing and installation. Opponents of nuclear power raise concerns about safety, dependence on government subsidy, huge upfront costs, decommissioning, handling of waste, and the spread of nuclear weapons. Safety has been greatly improved with the advent of failsafe designs that use passive cooling in a shutdown without relying on an operator. The cost of nuclear energy is greatly increased in the West by a failure to harmonise regulations and a failure to achieve economies of scale. The large upfront investment required by nuclear generation requires Government to underpin a long-term power purchase agreement, but in the context of today's energy prices, this no longer looks like a big subsidy. The issue of decommissioning legacy nuclear power plants has no easy solution, but won't recur with modern plants, designed with decommissioning in mind.

19. Sunniva Rose, "How bad is it really? Nuclear technology - - the facts and feelings", (2013) TEDxOslo.

20. See https://www.euronuclear.org/glossary/fuel-comparison/

21. IEA, "World Energy Outlook 2014", p. 347.

22. IEA, "Nuclear Power and Secure Energy Transitions", (2022) p. 7.

The handling of waste is a manageable issue, given the relatively small quantities of it. In the long run, the best solution is re-processing, if the costs can be brought down and capacity increased, as this would minimise reliance on the supply of newly mined yellowcake. The prevention of the spread of nuclear weapons is handled internationally via the Treaty on the Nuclear Non-Proliferation of Nuclear Weapons (NPT), signed by 190 nations, which tightly restricts who can produce nuclear fuel. This is being increasingly challenged not as a result of nuclear energy, but rather due to the rise of dictatorial regimes as discussed above in relation to the "resources curse".

A shift in opinion about nuclear energy can be captured by comparing the IEA's "World Energy Outlook 2014" with its 2022 publication "Nuclear Power and Secure Energy Transitions". The 2014 report stated that already then 75% of OECD nuclear plant was over 25 years old and showed how the recent construction of nuclear power plant had been predominantly in non-OECD countries, principally China, which was seeking to meet its fast-growing electricity demand through every available means.[23] The report noted the extraordinary difference in construction costs between the US and France, being up to 5x higher in the US, because in France, "there was a preference for fewer models, one technology supplier and one plant owner" [24] In other words, France achieved economies of scale. The report goes through in detail all the problems with expanding nuclear generation, in particular the requirement for a long-term stable power price and the availability of skilled nuclear engineers, painting a picture of uncertainty over the industry and not suggesting any urgency to reactivate the industry, even though it notes: "The shift in the power mix in the Low Nuclear Case increases global primary demand for natural gas by 166 billion cubic meters (bcm) (comparable to the current production of Qatar) and for steam coal by 156 million tonnes equivalent (Mtce) (approaching the current exports of Australia) in 2040." It suggests, without irony, "Energy self-sufficiency is not necessarily a desirable goal: when foreign energy supplies are available, affordable and reliable . . " [25]

The 2022 publication has a different tone. "Nuclear energy can help make the energy sector's journey away from unabated fossil fuels faster and more secure . . . The policy landscape is changing, opening up opportunities for a nuclear comeback . . . Energy security concerns and the recent surge in energy prices, notably in the wake of Russia's invasion of Ukraine, have highlighted the value of a diverse mix of non-fossil fuel and domestic energy sources."[26]

The revival of a nuclear power industry in the UK, based around the adoption of the latest innovations in fail-safe nuclear power installations, small modular reactors and the variable power output capabilities of new molten salt reactor designs, should be a key priority for UK energy policy, as well as that of the West more generally. However, from an investment perspective, there are currently relatively few ways to back this.

23. IEA, "World Energy Outlook 2014", pp. 347-8.

24. Ibid., p. 367

25. Ibid., p. 414

26. IEA, "Nuclear Power and Secure Energy Transitions" (2022), p. 7-8.

2. Defence

In the 1990s funds which described themselves as "Ethical" for the most part would rule out the defence industry completely, and there was some logic to this in that the industry of the 1990s was notoriously corrupt.[27] However, such an approach very quickly fails our Principle 5, in that if all market participants adopted this approach the West would become greatly weakened in a way more likely than not to provoke conflict. From this point of view, it is both perverse and dangerous to rule out investment in the defence industry wholesale. Following Russia's invasion of Ukraine, an unthinkable act just a decade ago, this point hardly needs to be made any longer. But Eisenhower's famous warnings about the rise of the military-industrial complex in his televised farewell speech prior to leaving office in January 1961 was really concerned with the possibility of regulatory capture, which in turn would provide licence for corruption and profiteering from the export of arms to oppressive states:

"In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex. The potential for the disastrous rise of misplaced power exists and will persist. We must never let the weight of this combination endanger our liberties or democratic processes. We should take nothing for granted. Only an alert and knowledgeable citizenry can compel the proper meshing of the huge industrial and military machinery of defense with our peaceful methods and goals, so that security and liberty may prosper together."[28]

Most publicly listed defence companies in Western markets play a crucial part in supplying equipment to the armed services of the UK, US, Europe, Australia and New Zealand, and since the end of the Cold War, there has been consolidation in the industry and a sense of collaboration amongst Western powers, whilst at the same time anti-corruption legislation has been greatly strengthened.

We recognise that there are many pitfalls to negotiate in investing in this sector, and that analysis of the risks around corruption can be difficult, particularly given that all of these companies are required to keep many aspects of their business secret. Transparency International has set up a useful website offering analysis and resources giving insight into the risks of corruption in different countries, and also offering reports on the risks around individual public companies. [29] However, given the strategic imperative for Western nations to have well equipped military services, it is essential that this sector remain part of the investable universe, and that far from being ethical to exclude it wholesale, we would argue it is deeply unethical to do so. [30]

Russia's invasion of Ukraine in Feb 2022 and their subsequent use of Iranian Shahed-136 drones to carry out war crimes highlights a further issue. The supply chains for advanced weapons systems likely to fall into the hands of violent, oppressive regimes and used for nefarious purposes extend well beyond defence companies to manufacturers of precision electronics and semiconductor components.

27. See Andrew Feinstein, *The Shadow World: Inside the Global Arms Trade,* (2012).
28. See https://avalon.law.yale.edu/20th_century/eisenhower001.asp
29. See https://ti-defence.org/gdi/
30. See *Financial Times*, "City investors putting UK security at risk over ESG, ministers warn", (30 July 2023).

A recent report from IPHR (International Partnership for Human Rights) has highlighted components from sixteen Western technology companies found in Shahed-136 drones salvaged in Ukraine, including Analog Devices, Infineon (via International Rectifier), Marvell Technology, Micron Technology, and Texas Instruments.[31] This is not to attribute any fault to these companies or to allege breach of sanctions, but it is clear that completely stopping the flow of technology to sanctioned regimes is profoundly difficult. With both defence companies and high-tech engineering and electronics companies, we would expect to deal with the risks of their products falling into the "wrong" hands through research and company engagement. We would expect companies in which we invest to be rigorous in mitigating this risk.

31. IPHR, "Terror in the Details: Western-made Components in Russia's Shahed-136 Attacks", (July 2023) p. 31.

3. Profiting from addiction

A cluster of highly profitable industries revolve around the phenomenon of addiction, raising a series of difficult questions for investors. Rather like monopoly businesses, it is the proper function of Government to get involved in regulating such companies and all do so. The question then is how much space opens up where investors are required to impose judgements on the adequacy of these regulations, and where this happens, how do we explain the basis for doing so? Personal preference does not provide adequate reason here. Rather fund managers need to form a judgement about where society as a whole is likely in the longer run to draw a line between the benefits of allowing a particular activity and the social harm it causes. Where the social harm side of the equation easily outweighs the benefits, there is a high chance that the profits of a business can disappear overnight through regulatory change. So it becomes sensible risk management to avoid such businesses. The judgements involved here are always going to be subjective to a degree, and so conclusions need to remain open to challenge as circumstances and public opinion evolves. A useful test to apply here is to ask: “if this company didn’t exist, would their community and customers be better off?”. Investors should be very wary of investing in businesses selling addictive products which are careless about the misery they might cause.

Alcohol & Tobacco

In respect of alcohol, for example, most Western countries have regulated the industry about as tightly as they are likely to, such that the boundary between leisure and social harm seems well-drawn where it currently is. Whilst addiction still frequently occurs, this risk is mitigated by legislation and the fact that the majority of alcohol consumers are not addicts. Companies actively seeking to encourage customers into addiction are likely to be put out of business. It feels like most Western countries have reached a long-term accommodation with alcohol. As such, we would regard pubs, restaurants, manufacturers of alcoholic drinks, and off-licences as part of the investible universe of companies. This applies more weakly to tobacco, where there is a strong sense that regulators would prefer that the industry didn’t exist, and to “risk-reduced products” such as vapes, in the sense that legislation is still nascent.

Gambling

In relation to the gambling industry, legislation has been more prone to industry lobbying. There is a line to be drawn between the provision of a leisure service, designed to enhance the enjoyment of a sporting event for example, and seeking to exploit addictive gambling behaviour amongst vulnerable groups. The latter can attract powerful vested interests, corrupt business practices and heavy-handed law enforcement. 20 years ago a company called Wembley Plc was listed in London. It had owned Wembley Stadium in its past, became over-leveraged and sold the stadium to the Football Association in 1999 for £106m. A few years later Wembley was earning 90% of its profits from a casino at their greyhound track at Lincoln Park, Rhode Island. It also owned greyhound racing tracks in the UK. The casino was, according to what analysts told me at the time, in a poor neighbourhood, principally serving slot machine addicts. The shares fell heavily in 2003 when the CEO, Nigel Potter, and the head of the US division, Daniel Bucci, were accused of conspiring to bribe a US official in Rhode Island. The allegations related to attempting to pay $4m to a lawyer, John Harwood, as a bonus. The problem was that John Harwood was also a senior state politician. It was suggested that this bribe was to secure 1,000 new video lottery slot machines at Lincoln Park, and also ensure that plans for a Narragansett Indian casino nearby were blocked.

The company effectively put itself into wind-up mode after this and did well for shareholders, as two big US casino companies bid up the value of Lincoln Park. But Nigel Potter, the CEO, was eventually jailed for three years in the US, being made a scapegoat. The point here is that the addiction-fuelled end of the gambling industry is fraught with legal risk for operators and is unlikely to be a place for a public company to be, and the powerful vested interests of large private companies operating in this space make for unpredictable problems.

Addictive Medicines

In the world of regulated medicines, the Sackler family, who owned Purdue Pharma, provides the case study for a pharmaceutical business which made a living through successfully developing the market for an addictive drug, employing a good deal of regulatory capture on the way. They were put out of business in the long run, facing multiple law suits and a criminal prosecution for the overprescription of OxyContin, an addictive opioid pain reliever introduced to the market in 1995. The story has been told in Patrick Radden Keefe's book *Empire of Pain (2021)* and in HBO's 2021 documentary *"The Crime of the Century"*. Had this been a listed company, we would not have regarded it as part of our investible universe. This said, it is highly unlikely that a business making money in this way ever would be a public company.

Social Media

Social Media deserves a mention here, because its skyrocketing usage depends at least in part on the brain chemistry of addiction. The social media business model is optimised by keeping users online as long as possible in order to trigger advertising revenues. The best way to do this, so the argument goes, is to prioritise the kind of posts which provide users with a dopamine release. Dopamine is the brain's "feel-good" chemical, its reward system. It appears to play an important role in addictive behaviours: according to a representative research paper by Wise and Robble in 2020, "most addictive drugs cause elevations in extracellular levels of the neurotransmitter dopamine".[32] The abstract of this paper summarises the process through which dopamine establishes behavioural patterns: "Burst discharges (phasic firing) of dopamine-containing neurons are necessary to establish long-term memories associating predictive stimuli with rewards and punishers . . . As a result of habitual intake of addictive drugs, dopamine receptors expressed in the brain are decreased, thereby reducing interest in activities not already stamped in by habitual rewards." It turns out the best way to drive this type of engagement, even stronger than latching onto what a user likes, is to provoke fear or anger. It's not necessary for social media to exploit this phenomenon, but it makes much more money if it does, and therefore companies face being competed away if they don't.

There are two impacts of social media to consider here. The first is upon mental health. It has become apparent that we are living through a mental health crisis focused on young people. A recent statement from the BMA, for example, notes that "the number of children and young people in contact with mental health services since 2016 has expanded at almost four times the pace of the psychiatry workforce." [33]The same pattern is evident in many developed economies, most notably the US, clearly exacerbated by COVID-19.

32. Abstract of Roy A Wise and Mykel A Robble, "Dopamine and Addiction", *Annual Review of Psychology*, (Jan 2020).
33. BMA, Press Release, (13 Oct 2022).
34. See American Academy of Pediatrics, "A Declaration of a National Emergency in Child and Adolescent Mental Health", (2021).

In October 2021 the American Academy of Pediatrics, for example, declared a national emergency in child and adolescent mental health. [34] Medical Health America (MHA) produces an annual report on the state of mental health in America. The 2015 report reported that 18.19% of adults in America suffered from a mental illness over the prior year, and 8.66% of 12-17-year-olds experienced at least one Major Depressive Episode (MDE). [35]

The same report for 2023 reported 20.78% and 16.39% for these figures.[36] This dramatic rise in depression amongst young people was undoubtedly accelerated by COVID, but it was already a persistent trend prior to 2020. One of the features of the COVID lockdowns was a sharp rise in the use of social media, and this is likely to have been especially the case amongst younger people. Whilst the figures for adults are estimated by Statista to have risen from around 55 minutes per day in 2019 to 65 after 2020, for adolescents the data is harder to source. A Pew Research study from 2018 for example said that "95% of teens have access to a smartphone, and 45% say they are online 'almost constantly' ",[37] which raises the point that time spent on social media is difficult to measure, as engagements are normally broken up across periods of other activity, creating the sense of being constant, whilst actually being intermittent.

The reality is that it is too early to tell how social media has impacted young people over the last 15 years or so. Good data is scarce and medical type studies seemed strangely awkward and ill-equipped to deal with the nuances of social media usage and different practices adopted by each platform.[38] In May this year the US Surgeon General published an Advisory, which in a measured way sounded alarm bells. It notes that social media use by youth is almost universal, and that the age restriction of 13 years is widely ignored, with 40% of children ages 8-12 being users. "At this time, we do not yet have enough evidence to determine if social media is sufficiently safe for children and adolescents. We must acknowledge the growing body of research about potential harms, increase our collective understanding of the risks associated with social media use, and urgently take action to create safe and healthy digital environments that minimize harm and safeguard children's and adolescents' mental health and well-being during critical stages of development."[39] Unfortunately the creation of healthy digital environments for children seems a distant prospect!

The second aspect of social media to consider is its impact on the body politic, its ability to manipulate and control public opinion, and to do so at the behest of the highest bidder. This was the issue highlighted by Carole Cadwalldr's now famous Ted Talk in 2019 about Facebook's role in Vote Leave's Brexit campaign, in which she discusses her three-year long investigation into the role of Cambridge Analytica, not just concerning Brexit, but also the election of Donald Trump.[40] This talk is specifically about Facebook, rather than "social media" generally. The chief point made was that Cambridge Analytica, in its work for both Vote Leave and Trump, profiled people politically using data provided by Facebook (unbeknown to the individuals involved) in order to understand their individual fears and establish which groups could be effectively targeted with Facebook ads tailored to their exact profile.

35. *Medical Health America*, "Parity or Disparity: The State of Mental Health In Amercia 2015", p. 15 and p. 19.
36. *Medical Health America*, "The State of Mental Health In Amercia 2023", p. 15 and p. 18.
37. Monica Anderson and Jingjing Jiang: "Teens, Social Media and Technology 2018", Pew Research Center.
38. See for example on of the largest scale studies of recent years, Riehm, Feder and Tormohlen: "Associations Between Time Spent Using Social Media and Internalizing and Externalizing Problems Among US Youth", *JAMA Psychiatry*, (2019) 76(12)1266-1273.
39. US Surgeon General's Advisory, "Social Media and Youth Mental Health" (May 2023), p.4.
40. Carole Cadwalladr: "Facebook's role in Brexit – and the threat to democracy", (10 June 2019) TED Talk. This talk was later the subject of a protracted libel case brought by Aron Banks, although the contested points of this case are incidental to the main message of the talk.

This was something new. “We are what happens to a western democracy when 100 years of electoral laws are disrupted by technology . . . It’s not about left or right or ‘Leave’ or ‘Remain’ or Trump or not. It’s about whether it’s actually possible to have a free and fair election ever again.” This may be underestimating the ability of societies to adapt to new technology, but it remains a challenging question that deserves much greater scrutiny.

It is interesting to compare and contrast the rise of social media with rise of the tobacco industry. Both were at the epicentre of extraordinary levels of rapid growth and wealth creation that profoundly shaped society. Both grew rapidly in virtue of little understood addictive behaviour. We know that smoking tobacco created severe health problems, we don’t yet fully understand what negative impacts are caused by social media, albeit that we know they can be serious. Tobacco was first brought from America to Europe by Christopher Columbus in 1492. It was first cultivated as a commercial crop in Virginia in 1612 by an Englishman, John Rolfe, and within seven years it became the colony’s largest export. The rapid growth of the industry in North America and the Caribbean in turn fuelled a huge expansion in the slave trade over the following two centuries. In the 19th Century the industry became mechanised and industrialised. Serious health concerns only began after 1900, when an increase in lung cancer amongst smokers began to be noticed and the impact on the heart, blood vessels and lower respiratory tract also began to be studied. This did nothing to stem the continued growth of the industry. When in the 1940s evidence of a causal link to cancer strengthened, the industry responded by coming up with filter tips for healthier smoking. In 1964 the US Surgeon General issued a 387 page health advisory, providing the first comprehensive analysis of the health risks, and this set out in detail a range of severe health hazards from smoking, concluding in the understated style of officialdom: “Cigarette smoking is a health hazard of sufficient importance in the United States to warrant appropriate remedial action.”[41] After a few decades of regulation based on restricting marketing practices, it was only in the 1990s that the tobacco industry began to face major lawsuits in the US, holding it to account for the premature death and sickness it had knowingly caused.

It took nearly 400 years for the tobacco industry to be effectively regulated and then fined for a small proportion of the damage caused. This will probably happen a lot faster with social media, but it will still take a long time. This is a classic example of an industry creating new arenas in which the pre-existing “rules of the game” are hopelessly inadequate, and likely to be so for many years. Investors in social media therefore need to be discerning about good and bad practice, being willing to refuse to invest in the platforms that pay inadequate heed to the damage they can cause, perhaps in the expectation that they will eventually be held to account for it, but perhaps just in the belief that there is an overriding interest for all of us (and hence also the investors in the funds we run) in putting pressure on such companies to take their responsibilities more seriously.

41. US Dept of Health, Education and Welfare, “Smoking and Health, Report of the Advisory Committee to the Surgeon General of The Public Health Service”, (1964) p. 33.

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