Responsible Investing

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PLATYPUS
ASSET MANAGEMENT

Defending ESG

ESG investment sentiment has historically been negative towards defence companies. In this note, we look at the macro context of defence investment, the nuance of fiduciary duty, arguments for and against defence investment, and provide some comments around investor considerations when investing in defence companies.

Defence spend is increasing

Uncertainty within the global political environment has escalated over the past half-decade. One consequence is the change in global spending on defence: 2024 was the single largest percentage increase in defence spending since the Cold War.

Exhibit 1: Total global defence spending

Year	Global defence spending ($US billion)	Real growth (%)	Proportion of GDP (%)
2022	2,000	3.5	1.59
2023	2,240	6.5	1.8
2024	2,718	7.4	1.94

Source: Australian Government[1] and Platypus

The highest spending 15 countries account for ~80% of total defence expenditure and while the US is ~26% of world GDP, it contributes ~37% to global spending. In 2024, Australia spent US$33.8 billion on defence and ranks 15th globally. Ukraine spends 34% of its GDP on defence, while Israel spends 8.8%.

Spending expectations

Government announcements point to future increases in defence spending both in absolute terms and as a percentage of global GDP.

NATO In June, the 32 members committed to 5%[2] of GDP by 2035 for defence, consisting of 3.5% to core defence and 1.5% to resilience investments, e.g., cyber-security. This has been increased from 2% pledged in 2006. The UK has committed to meet these targets, while at the time of writing France is more cautious.

EU Released a White Paper[3] in March that details plans for defence spending in the current global strategic context. Currently, the EU spends 1.9% of GDP on defence and in the White Paper it was claimed possible for member states to increase defence spending by up to 1.5% of GDP.

Japan In 2022, announced plans to increase defence spending to 2%[4] of GDP by 2027. This remains unchanged as at the time of writing.

Australia Plans to increase defence spending from 1.9% in 2024 to 2.4%[5] of GDP by 2034.

[1] Rising global defence expenditure

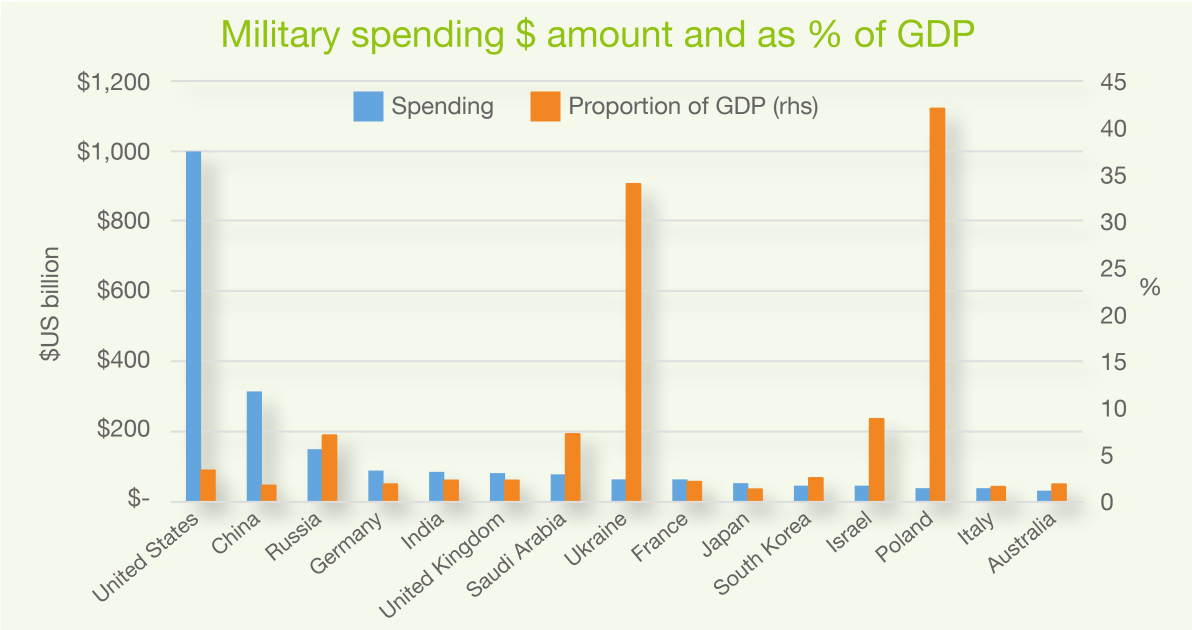
[2] NATO - Topic: Defence expenditures and NATO's 5% commitment

[3] ReArm Europe Plan/Readiness 2030

[4] Japan Targets 2% Defense Spending | Nippon.com

[5] Rising global defence expenditure – Parliament of Australia

Exhibit 2: Global defence spending by country (2024 data). Data for China, Russia, and Saudi Arabia is estimated.

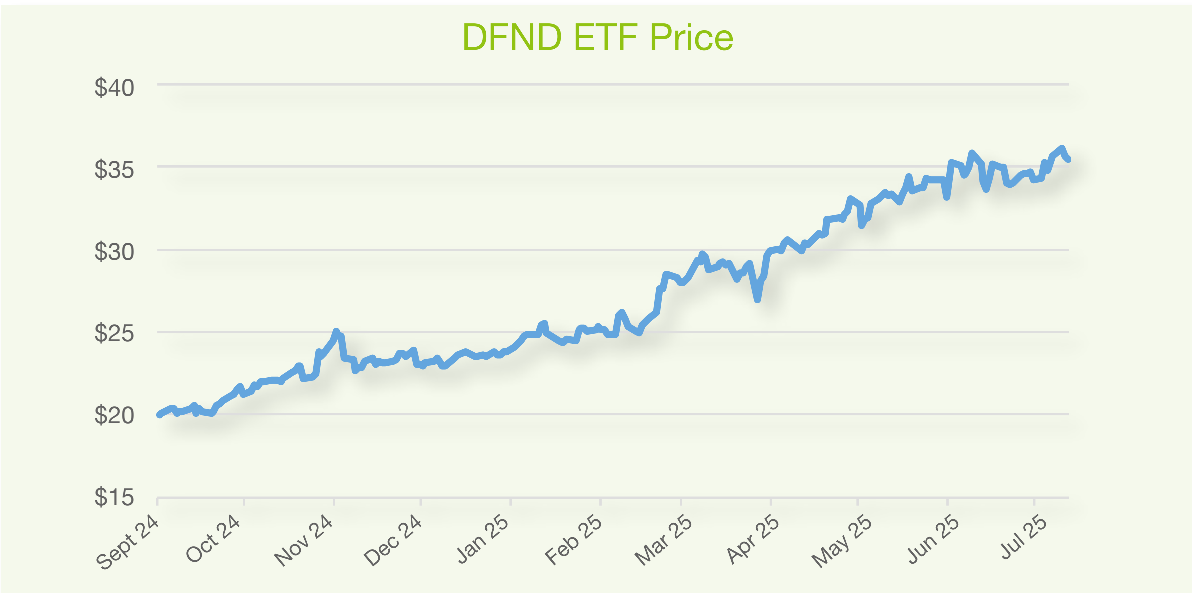


Source: Ibid

Defence spend is increasing

As global security investment has increased, stocks with exposure to the thematic have performed well. The ASX listed DFND[6] ETF represents a basket of defence-related stocks listed across global markets. Top holdings include Palantir, RTX Corp, Leonardo SpA, Thales SA and Hanwha Aerospace.

Exhibit 3: Performance of DFND ETF



Source: Bloomberg, Platypus. Past Performance is not a reliable indicator of future results.

To be clear, we are not making a prediction about future performance - in this note, we are highlighting the nuanced issues that defence stocks pose for global investors that have an ESG lens.

[6] DFND - VanEck Global Defence ETF | Defence Stocks

Legal framework for trustees

In January this year, Judge O'Connor found that American Airlines and its Employee Benefits Committee breached their fiduciary duty by incorporating ESG factors into their BlackRock-managed investment strategies.[7] In his ruling, Judge O'Connor defined ESG investing as a strategy that considers a non-pecuniary interest as an end in itself rather than a means to some financial end. In essence, for pension funds in the US, the ruling supported the primacy of financial returns. While US focused, this ruling has impacted investment thinking with respect to ESG globally.

Here in Australia, Justice Jackman[8] penned an article for the Law Council of Australia Superannuation Lawyer's conference that examined the legal framework for the duty of superannuation trustees to their beneficiaries.[9] He makes a number of interesting points about trustee responsibility from both an investment and operational perspective: 1) trustees must generally prefer financial gain to social and political concerns, but that does not mean ignoring those same concerns, 2) shareholder activism, including voting, directed towards advancing trustees' social and political views would be open to legal challenge, 3) larger fund size is only better if it can be made clear that a larger fund will provide financial benefits for members, which includes any impact on investment opportunities.

He concluded:

> *'Parliament has taken the view… that it is best for superannuation trustees to suppress what they may perceive to be noble virtues until they have first exhausted the pursuit of their beneficiaries' financial interests.'*

Unless the fund has specific exclusions and is presented as such, trustees have a legal responsibility to consider members' best financial interests first.

This brings us to defence. Excluding defence stocks en masse from general offer funds should take account of the financial implications of doing so. This is difficult, because any analysis would have to take account of alternative capital allocation and the risks and rewards of that different investment decision. For a complete understanding, it would be necessary to incorporate factor exposure (e.g., value, growth, momentum) into the return attribution.

In this light, we consider some arguments that support or challenge defence investment from the perspective of an investor for which ESG considerations are important.

Supporting defence investment	Comments
Defence acts as a deterrent. The best case is where capability is not used and peace is maintained. Historically, credible deterrence can be thought of within the framework of the 'three Cs': capability, commitment, and communication.[10, 11] Presently, there is global investment in capability, supporting commitment and communication. Commitment requires a willingness to use national capability, and communication involves conveying intent, all while demonstrating resolve.	While the deterrent argument is theoretically supported by game theory,[12] from a practical perspective it raises the following points: • It is not possible to calculate what percentage of GDP spend is enough to achieve sufficient deterrence. For example, in 1960 global defence spending as a proportion of GDP was 6%, three times higher than today.[13] • There is an underlying value judgement inherent in increased military spending by liberal democracies. Using military power wisely is often nuanced and there are examples of liberal democratic societies that have not fully supported military action by elected officials. From an investor perspective, the trend of GDP investment has direct implications. As defence spending increases, investors should consider whether this implies that conflict risk will also increase. In markets, feedback loops are common[14] and can give rise to both risks and opportunities for investors.

[7] 33dcaf44d1b611ef94db7e6b1fe1324a

[8] Fun fact: Justice Jackman is the brother of actor Hugh Jackman.

[9] Superannuation trustees' duty to make money for their beneficiaries

[10] David J. Lonsdale, Extended Deterrence: Back to the Future, No. 541, December 1, 2022 – Nipp.

[11] For a good summary, see Citi Research: Event Replay | Revisiting the Negative Consensus on Defence: When the Facts Change | 10-Apr-2025

[12] Game Theory (Stanford Encyclopedia of Philosophy)

[13] Military expenditure (% of GDP) | Data

[14] See Boom and Bust for example.

Supporting defence investment	Comments
Defence spending supports research and development that often has broad societal benefits. Notable societal impacts include the Global Positioning System (GPS), the internet (which evolved from a US Department of Defence project called ARPANET), and the first electronic general purpose computer. Present projects listed on the Defence Advanced Research Projects Agency website[15] include anti-money laundering algorithm research, investigating bioelectronics for tissue regeneration, and various quantum computing projects. Another example is sustainable aviation fuel (SAF). As far back as 2010, the US military flew a modified Boeing F/A-18E/F Super Hornet using a 50:50 blend of SAF and jet fuel. In 2022, the Royal Air Force flew a military aircraft using 100% SAF. At the time of writing, the French military are presently working towards 100% SAF use in NH90 helicopters.[16]	In our view, this is one of the most compelling arguments for defence spending. Private capital has return requirements that are generally too restrictive for blue-sky research and development. Additionally, because the motivation for defence research is not capital return, when research outcomes move to the public domain, societal impacts are sometimes not limited by patent (e.g., GPS). Finally, large industrial projects, such as SAF, can leverage defence infrastructure in a way that smaller scale laboratory research cannot.
Defence research can create tools for human rights abuse. One motivation for defence research is the creation of harmful weapons. In some sense, the worse the weapon, the better the deterrent. Once created, time is then spent constructing resolutions and treaties to limit use. This is the focus of the United Nations Office for Disarmament Affairs (UNODA), which provides support in the area of the disarmament of weapons of mass destruction (nuclear, chemical, and biological weapons).[17]	We agree that this is a risk for investors. In our view, allocating capital to businesses that produce weapons that violate UNODA conventions would be difficult to justify whether viewed from the perspective of an ESG investor or not.
Rather than investing in defence companies, private capital could be better used elsewhere. For better societal outcomes, capital should be invested to benefit humanity, not create weapons. For example, with respect to the energy transition, the IEA estimate that to achieve net zero by 2050, USD$5 trillion annually will be needed by 2030.[18] The more private capital can contribute, the better.	We do not think these are necessarily mutually exclusive. Defence as part of a larger ecosystem can help. There are a number of technologies that are yet to be cost competitive with their fossil fuel equivalent, and so public funding combined with legislation are required to increase the speed of uptake. Following on from our comments above, SAF is a good example - see here for our report.

[15] Programs | DARPA

[16] The Future of Sustainable Synthetic Fuel in Military Aviation » Karve

[17] Weapons of Mass Destruction – UNODA

[18] Net Zero by 2050 – Analysis - IEA

Investor considerations

For investors who plan to invest in defence companies, we think the following are important:

Governance has to be of the highest standard. Defence companies will be held responsible by the equity market for governance breaches that result in products being used in unintended ways. As a consequence, supply chains should be well understood and monitored by management above and beyond any legal requirement. As investors, we believe this should be a primary focus of both company understanding and engagement.

Best case is that companies should have added benefit in addition to defence. A clear benefit to society beyond defence strengthens the business case. This protects investors if defence spending slows as well as helping provide broader justification for investment from an ESG perspective.

A case by case approach is essential. In our view, investors should take a stock specific approach to defence investing. Investing in companies that are creating products that cause harm requires a strong understanding of the business model and embedded risks.

Communication is an important part of the overall approach. Superannuation fund members should be able to understand the risks and rewards of the capital allocation of their fund, especially when there are nuances around the investment case. Transparent and accurate communication is vital to avoid the penalties associated with greenwashing.[19]

[19] How to avoid greenwashing when offering or promoting sustainability-related products | ASIC