New DOL Guidance on ESG Investing Is Opportunity To Upgrade a Plan's Investment Policy and Practices

Consideration of Environmental, Social, and Governance factors can enhance a DC plan's investment lineup.

By Robert E. Pike and Matthew W. Sherwood

On April 23, 2018, the Department of Labor (DOL) issued Field Assistance Bulletin 2018-01, which provided updated guidance around two key issues for investors: the exercise of shareholder rights, and the evaluation of "economically-targeted investments." We believe plan sponsors can make the case that the new guidance is perfectly in keeping with industry best practices which are seeing a new emphasis on A) exercising voting rights to create long term sustainable investment value and B) including ESG factors as an inherent part of "generally accepted investment theories."

Note first that "economically targeted investments" (ETI) is a term unique to the lexicon of government. ETI means investments which feature "collateral economic or social benefits" in addition to investment returns. In practice, the marketplace has come to define these investments as utilizing "socially responsible investing" (SRI) methods of analysis, or using "environmental, social, and governance" factors in selecting investments (ESG). We'll use ESG as the catchall term for brevity throughout this article.

Background

ESG has grown significantly over the years as asset owners have come to understand that their collective voice can influence the policies and practices of the companies they own for the better. Beginning most notably with the anti-apartheid divestment campaign from South Africa in the 1980's, investors have broadened their perspective to encompass multiple lenses through which to evaluate investments, instead of just using traditional measures of financial analysis like price to earnings, price to sales, price to book and the like.

Rather than permanently excluding certain categories of investments (like alcohol or tobacco securities) from consideration, the most common approach now is to include all categories of investments, but meaningfully favor those investments with strong ESG attributes. While the attributes themselves are not uniform and are still evolving, they share the distinction of identifying positive elements that contribute broadly to long-term economic value creation. As an example, the carbon intensity of companies are measured and ranked, with low carbon "footprint" companies receiving higher ESG scores (a more favorable investment attribute). For more background, see also "ESG, SRI, and the New World of Investing to Make a Difference" from the Summer 2016 issue of "Defined Contribution Insights".

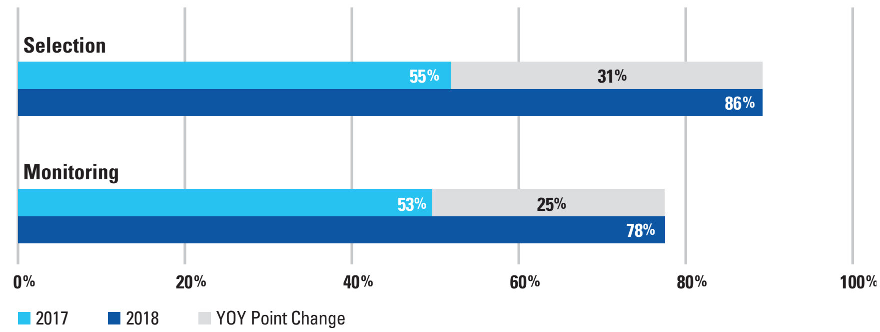
The Rise of Intangibles

A key driver in the rising use of ESG is the dramatic shift from a manufacturing, hard-asset, economy to an information-based economy. Increasingly, market value and future earnings streams are derived from intangible assets rather than physical assets. In 2015, public market valuations were comprised of 84 percent intangible assets and only 16 percent tangible assets, a complete reversal from 1975 when the mix was 17 percent and 83 percent respectively.[1]

The phenomenal growth of asset-light businesses over time is the result of technology-enabled businesses, in many cases reliant on intangibles such as a powerful network and the effect of a broad-ubiquitous user base or ecosystem. This transition in the structure of business is reflected in writings such as "The Capitalist's Dilemma" by Clayton Christensen and Derek van Bever, and "The End of Accounting and the Path Forward for Investors and Managers" by Baruch Lev and Feng Gu.

Businesses like Apple, Amazon, Google, and Facebook all fit a general paradigm of growth unconstrained by high capital investment requirements. As a result, asset-intensive accounting and measurements paint an incomplete picture of the business. Investors and corporate managers need to be attenuated to issues of social license to operate, impact, and ESG factors as part of the overall financial factors assessment. ESG factors enable analysts and money managers to better understand the intangible assets of companies, which assist in the decision-making of whether to purchase a company's stock or credit.

Exhibit 1: Asset owners considering ESB/active ownership in the selection and monitoring of external managers



Source: UN Principles for Responsible Investment 2018 Annual Report

Recent Developments

As a critical validation of this broadening analytical framework, the world's largest professional organization dedicated to training and credentialing security analysts and portfolio managers, the CFA Institute, formally defined and adopted ESG factors as part of their standard analytical framework in 2015, concluding that *"…systematically considering ESG issues will likely lead to a more complete investment analysis and better-informed investment decisions."* Inherent in this decision was the understanding that the analysis and management of material risks is a key driver in the creation of long term economic value (i.e., return on investment). This framework has been incorporated into their body of knowledge and is now an important part of the curriculum and testing program for all the world's aspiring investment analysts. (Visit https://www.cfainstitute.org/en/advocacy/issues/esg-sustainable-investing for more information on ESG).

Plan sponsors should regard this development as irrefutable evidence that, if DOL requires plan fiduciaries to consider *both* the risk and return of competing investments in their fund/manager selection process, then ESG forms the most complete and comprehensive framework for investment evaluation. It is, furthermore, now a core (albeit newer) feature of "generally accepted investment theories" which are consistently referenced in DOL guidance and other fiduciary publications.

With respect to shareholder rights (activism), the marketplace received a wake-up call earlier this year. In perhaps one of the notable investor letters ever written on the subject of ESG, the chairman of the world's largest money manager, Larry Fink of Blackrock, wrote in January to all of America's CEOs, stating that *"Society is demanding that companies, both public and private, serve a social purpose… to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."* He goes on to state that *"a company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process."*

Fink specifically noted that even stewards of passive investments (i.e., index funds) have a responsibility to vote their shares in a manner consistent with sustainable, long-term growth using ESG. Blackrock (and many other professional investors) are devoting significant resources to actively engage with owned (and non-owned) companies to de-emphasize short-term profit-seeking activities in favor of what is now properly understood to be the drivers of sustainable long-term value creation: the holistic integration of standard financial metrics as well as the environmental, social and governance aspects of the organization within the marketplace.

Marketplace Response

Institutional investors and investment managers have taken note. The latest report from the UN's Principles for Responsible Investing shows that a stunning 86 percent of asset owners globally consider ESG when selecting/evaluating investments, with 78 percent incorporating ESG in their monitoring activities. See Exhibit 1.

The US has long lagged the rest of the world in ESG adoption rates. Still, the longest running US-based ESG survey ("US Sustainable, Responsible, and Impact Investing Trends" published by the US SIF Foundation), noted in its 2016 biennial edition that *"SRI investing continues to expand-now accounting for more than one out of every five dollars under professional management in the United States."*

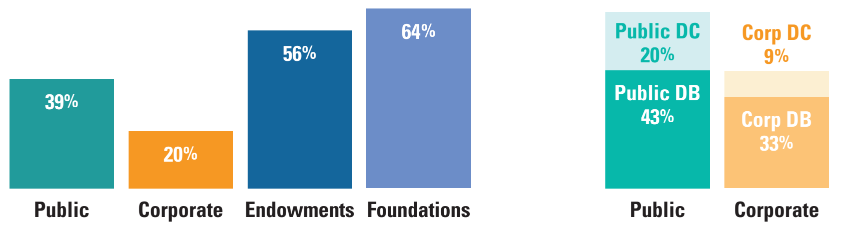
However, while large endowments, foundations, and public pension funds are leading adopters of ESG, the data show much lower usage rates among qualified retirement plans, especially defined contribution plans. In the just released 2018 Callan Associates Survey, just 9 percent of DC plans utilized ESG, versus 20 percent for public DC plans, and 39 percent for public funds overall. See Exhibit 2.

According to PSCA's own annual survey of 401k and profit-sharing plans, just 2.4 percent had ESG funds in 2016. Why is this?

DOL Guidance on ESG

DC plan executives frequently cite the conflicting and contradictory guidance from the DOL as impediments towards adopting ESG. Early DOL guidance stated, *"consideration of collateral, non-economic factors in selecting plan investments should be rare."*[2] This lead to the widespread impression that ESG factors should only be used as "tie-breakers" when investments with

Exhibit 2: 2018 funds that are incorporating ESG factors into investment decisions



Source: Callan Institute 2018 ESG Survey

comparable risk and return characteristics are under consideration.

Recognizing this confusion, DOL issued Interpretive Bulletin (IB) 2015-01, which clarified the tie-breaker notion: *"ESG issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investing choices."*

This statement is completely consistent with now standard worldwide methods of analysis (utilized by the CFA Institute, Blackrock, and others), which broaden the application of traditional financial factors to identify additional sources of risk or return.

In spite of this common-sense thinking, the latest DOL guidance seems, once again, to discourage the use of ESG. In Field Assistance Bulletin (FAB) 2018-01, the DOL states: *"Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors…that the investment is a prudent choice for retirement or other investors."*

This latest guidance is not helpful, and, moreover, does not reflect best and standard practices by investment managers worldwide, who increasingly consider ESG factors to be supremely relevant economic factors. Rather than focusing on the latest (conflicting) stance on ESG by DOL, plan fiduciaries should instead focus on the "green light" already given them (from IB 2015-01): *"If a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from (ESG) factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote."*

In other words, the sole focus should always be on the investment merits of the fund, manager, or strategy in question. Whether an investment utilizes a value, growth, or blend style, etc. or ESG, is a secondary consideration. Seen in this light, a plan fiduciary now has an opportunity to review policies and procedures (spelled out in writing in the Investment Policy Statement, or IPS) for selecting plan investments, and to add new or update existing language relating to ESG.

IPS Considerations

This is an exceptionally opportune time to include ESG considerations in an IPS. Asset owners and institutional investors worldwide are "already there" and, perhaps more importantly for DC plans, younger investors overwhelmingly prefer ESG. If the goal of any DC plan is to increase participation and improve retirement outcomes, and if companies want to build employee loyalty and workplace satisfaction, then including ESG investment options can go a long way toward achieving these synergistic goals, consistent with the unique profile and preferences of the plan's participants. (Importantly, the DOL does not require any language around ESG; in IB 2016-01 they simply state that the IPS is permitted to include policies concerning the use of ESG factors to evaluate investments.)

When considering new or updated language for an IPS, it is useful to reiterate that all investments will be evaluated based on their economic merits alone, consistent with the prime fiduciary directives of ERISA Sections 403 and 404 to act with prudence and diversify plan investments, while acting solely in the interest of the plan's participants and for the exclusive purpose of providing benefits.

Note here that the "exclusive benefit" directive is where ESG/ETI has generated such controversy and mis-understanding. The DOL and others have long considered the pursuit of social and environmental goals as "unrelated objectives." But as has been demonstrated in the marketplace, in reality, these aspects of an investment are key risk factors that can have an enormous impact on the economic viability of said investment.

It is common for an IPS to reference methods of analysis that conform to "generally accepted investment theories" (indeed this phrase appears in numerous DOL writings), which we would argue now include ESG considerations. In any case, when considering ESG language in an IPS, it is useful to reference either directly or by paraphrase the DOL's long-standing position that *"ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals."*

FAB 2018-01 in fact provides succinct instructions for integrating ESG factors into an IPS (footnote 6): *"A decision to designate an investment alternative may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments. For example, a plan fiduciary could adopt an investment policy statement with prudent criteria for selection and retention of designated investment alternatives for an individual account plan that were based solely on economic factors, and apply that policy to all investment options, including potential ESG-themed funds."*

In sum, a plan's investment selection and monitoring processes and procedures should be well defined and documented. Rather than treat ESG investments as exceptional items, an IPS can simply reference them as being part and parcel of the complete opportunity set that is examined when selecting any Designated Investment Alternative (DIA) within a plan.

Where's the Beef?

There is mounting evidence that investment performance can be enhanced using ESG criteria. In the parlance of investment management, this is known as a "risk premium." Many plan sponsors invest with systematic or active money managers, such as those strategies offered by State Street, Dimensional Fund Advisors, and Blackrock, that assess financial factors through the cross-section of returns as evident in such "risk factors" or "risk premia." These "factors" were identified by Nobel prize winners Eugene Fama and Kenneth French more than 20 years ago in their initial research. In 2014 they presented a study entitled "A Five Factor Asset Pricing Model," measuring the extent to which investment risk premium, market risk premium, size risk premium, profitability risk premium, and value risk premium explain the probability distributions in average stock returns (2014).

This year, in "The Journal of Investment Management", the study "Establishing ESG As Risk Premia" asserted that the professional forecasting displayed through ESG research and cross-sectional ratings yield significant insight into the probability distribution of long-term risk-adjusted equity returns, establishing ESG as independent risk premia (Pollard, Sherwood, and Klobus, 2018).

Further the financial risk factor efficacy of ESG risk premia is evident in the data. For example, since MSCI created the MSCI Emerging Markets ESG Index in June 2017, it outperformed the MSCI Emerging Markets Index by an annualized 32 bps, through 2016, and did so with a lower beta and volatility profile.[3]

Exhibit 3: Low-Carbon Funds' Performance Compared With Category Peers

	Low-Carbon		All Others	
Large-Brand Category	Return % (Annualized)	# of Funds	Return % (Annualized)	# of Funds
3-Year				
Passive	12.2	14	11.8	110
Active	10.1	72	10.4	236
5-Year				
Passive	12.9	12	12.5	95
Active	11.0	71	11.2	225

Source: Morningstar Direct, July 2018. Based on net returns of funds' oldest share class.

Plan sponsors and their advisors no doubt have access to investment evaluation tools to assist them in comparing the risk and return of competing investments (i.e., Bloomberg, Morningstar Direct, FactSet, fi360 Toolkit, etc.). In a recently published article,[4] Morningstar's director of sustainability research Jon Hale examined all "low-carbon" equity funds vs. broad market equity funds, and found similar performance. See Exhibit 3.

Note particularly that low-carbon passive (index) strategies outperformed by 40 basis points over the 3- and 5-year periods, and active "underperformed" by 30 basis points or less.

This study is consistent with a mounting body of evidence demonstrating that ESG investments do not meaningfully impair investment potential. In fact, it is quite possible (as with many non-ESG investments) that risk and return can be *enhanced* through the selective use of carefully considered ESG strategies. As this is the ultimate goal of any investment steward, it is eminently reasonable for ESG to now be included as a "normal and customary" factor by which to evaluate investments.

In Conclusion

ESG investments have become mainstream and are widely available for use in DC and DB plans. Over time, as more and more ESG strategies (especially mutual funds) present three-to-five year "track records," plan fiduciaries can evaluate these funds as they would any other investment option, not to promote any "collateral benefits," but to provide powerful investment vehicles that utilize a more complete set of risk management tools than those relying on traditional analysis.

PSCA has published the "ESG Resource Guide" as Module 3 of its Plan Sponsor Tool(k)it™ which can help plan sponsors get started. A very useful "first step" is to develop and circulate a short survey to gauge participant interest and preferences. Corporate mission, vision, and values statements should provide key elements in the development of such a survey.

In the end, smart plans will add ESG options now. Not only does it form a more complete opportunity set for investment risk and returns, it is a best practice globally, and is a key differentiator / loyalty driver for younger participants and potential new hires.

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[1] Ocean Tomo, Ocean Tomo's Intangible Asset Market Value Study, September 2017.

[2] DOL Interpretive Bulletin 2008-01

[3] Sherwood, M. W. and J. Pollard. "The Risk-Adjusted Return Potential of Integrating ESG Strategies into Emerging Market Equities." Journal of Sustainable Finance and Investment (2017): 1–19.

[4] "Investing In a Core Low-Carbon Fund", Jon Hale, Morningstar.com (August 16, 2018)