Sustainable Invest

Post-

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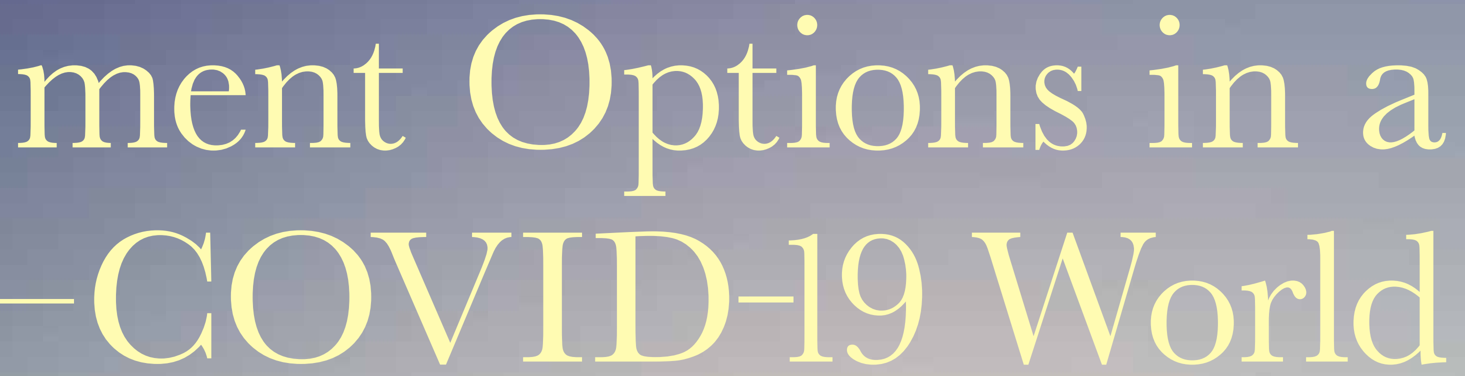


by | **Linsey Schoemehl Payne**

The COVID-19 pandemic and new guidance from the Department of Labor are among the issues retirement plan sponsors must consider when evaluating environmental, social and governance (ESG) investing strategies.

COVID-19 and the resulting economic recession have created the first sustainability crisis of the 21st century. As the virus spread across the globe in late March 2020, the global economy came to a screeching halt, and stocks experienced a record-breaking decline.

While no sector was left unscathed, some relative winners and losers were identified. Research showed that investment strategies that integrated environmental, social and governance (ESG) factors into their approach provided more downside protection compared with those that did not.[1] ESG integration is a returns-based approach, using ESG factors as an additional source of information during the investment manager's risk analysis process. The integration is typically based on *financial materiality*, meaning certain ESG factors are more or less relevant to certain industries. For example, when assessing a bank, social issues (such as predatory lending and access to capital) are more relevant than environmental issues, such as water usage. This outperformance continued throughout the year as ESG integration strategies kept pace in the ensuing rebound.

Last year also brought new guidance from the U.S. Department of Labor (DOL) on the use of ESG strategies in retirement plan investment offerings. Use of these strategies by institutional investors is on the rise. According to a 2019 survey of 800 institutional investors representing $16 trillion of assets under management across Europe, North America, Latin America and Asia, only 11% reported no use of ESG considerations.[2]

In light of recent investment trends and regulatory guidance, how should plan sponsors react? This article will discuss performance trends for ESG investments, the impact of the recent DOL guidance and steps for evaluating ESG performance.

ESG Performance

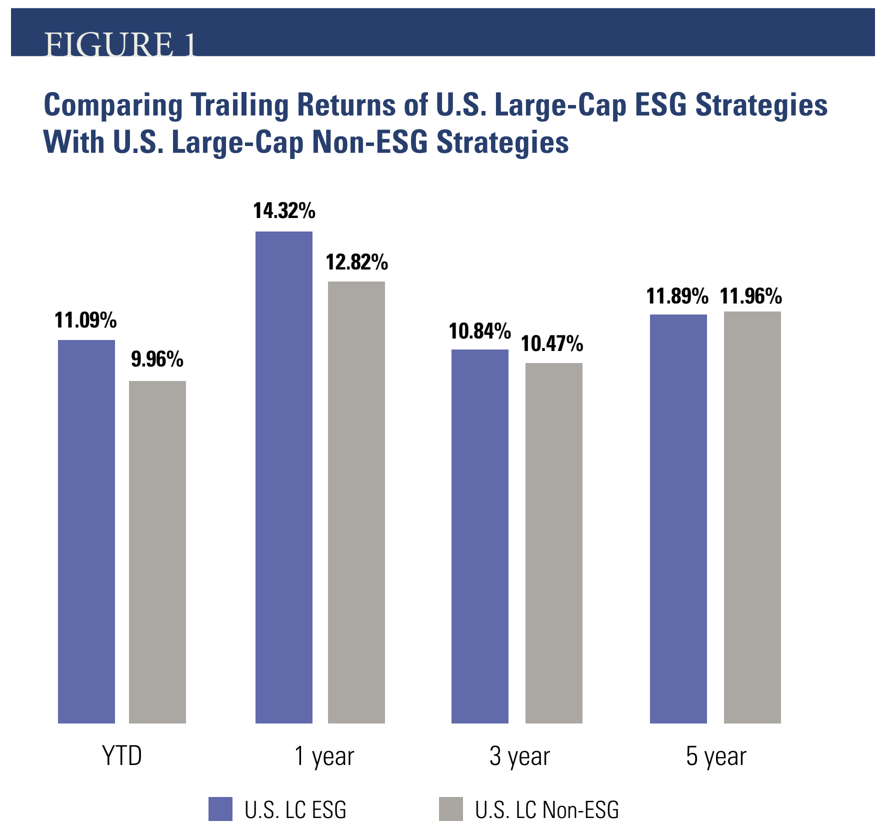
When constructing an investment lineup for defined contribution (DC) plans, the hope for plan sponsors is to provide their participants with the opportunity to build strong portfolios to help them generate adequate retirement income. With interest rates at historical lows, equities will likely need to play a larger role in wealth accumulation going forward. In fact, this is part of the reason DOL has recently issued guidance allowing for the use of certain private equity investments in participant-directed individual account plans, such as 401(k)s.

Equities are also the largest source of traditional portfolio volatility. As such, plan sponsors look at the Sharpe ratio, which measures risk-adjusted returns, when analyzing both new and existing investment options within their respective plan lineups. Figures 1 and 2 show the trailing returns and Sharpe ratios (as of November 30, 2020) of 1,175 U.S. large-cap strategies, distinguishing between those that identify as integrating ESG factors into the traditional financial analysis and those that do not.[3]

Over the trailing one-year period, funds that integrate ESG factors have outperformed their nonsustainable counterparts by 150 basis points and have produced similar returns when looking over a longer term. These performance trends persisted in the non-U.S. large-cap and global large-cap

FIGURE 1

Comparing Trailing Returns of U.S. Large-Cap ESG Strategies With U.S. Large-Cap Non-ESG Strategies



space as well when comparing funds that integrate ESG factors and those that do not.

When looking at risk-adjusted returns as measured by the Sharpe ratio, ESG integration funds have the upper hand within this group of funds. This essentially means that investors in these ESG integration funds appear to have benefited from higher returns without taking on additional risk. Critics of sustainable investing have often argued that these "feel-good" investments come at the expense of returns and would therefore be in violation of a plan sponsor's fiduciary duty to the underlying plan participants. Over the past few years, evidence has been building to show that, in fact, the opposite is often true: Poor corporate stewardship tends to result in underperforming stocks.[4]

While they are subject to ups and downs like other investments, sustainability-focused funds have proved to be resilient during times of market turmoil.[5] Some of this recent outperformance can be attributed to the fact that most ESG integration strategies either exclude or underweight the energy sector, which was down 36% for the year as of the end of November.[6] However, there was also similar protection from sustainability-focused funds during the late 2018 market downturn.

Proponents of ESG investing view companies that incorporate sustainability factors into their businesses as higher quality and, in turn, as having lower volatility. These companies also tend to attract risk-averse investors during times of market turmoil and are often viewed as more agile and transparent. The ability to quickly adapt to shifts in business, social and economic practices will likely continue to be vital to a company's success going forward. This includes continued changes within the regulatory environment. For example, now that the Democratic Party controls both chambers, legislation surrounding climate change is expected to surface in the near term. Companies that are not positioned to adapt could be negatively impacted.

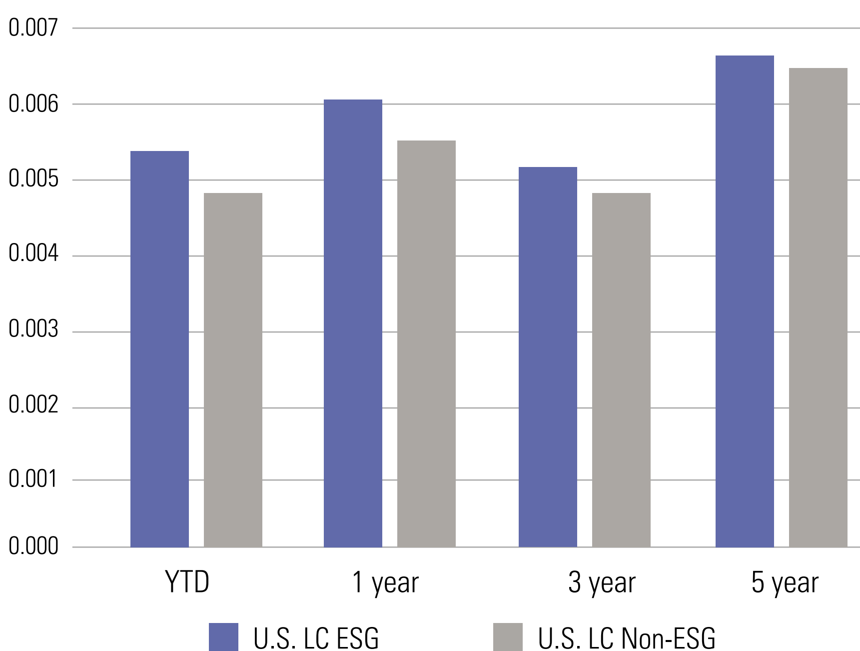
Recent DOL Guidance

One of the concerns about the use of ESG investments in retirement plans has been whether incorporating ESG considerations into an investment approach is in line with a plan sponsor's fiduciary obligations. Guidance from DOL, as the primary regulator of Employee Retirement Income Security Act (ERISA) plans, has been unclear at times.

Its most recent guidance was issued October 30, 2020 in the form of a final rule regarding the use of ESG factors in selecting investments. The rule states that ERISA requires plan fiduciaries to make investment decisions solely based on *pecuniary factors* (i.e., factors that a fiduciary prudently determines are expected to have a material effect on risk and return in light of the plan's investment objectives and funding policy and may include certain ESG factors), except in the event of a "tie-breaker."[7] The *tie-breaker* term refers to the "all things being equal test" (established by prior DOL guidance), which means that when a fiduciary is unable to distinguish between reasonably available investment alternatives based on pecuniary factors alone, the fiduciary may consider nonpecuniary factors, includ-

FIGURE 2

Comparing Sharpe Ratios for U.S. Large-Cap ESG Strategies With U.S. Large-Cap Non-ESG Strategies



ing ESG factors that are not financially material to the investment. DOL cautions that consideration of nonpecuniary factors should be rare and requires that such consideration be consistent with the duty of loyalty, which requires fiduciaries to act solely in the interest of plan participants and beneficiaries.

The final rule also requires plan sponsors to provide additional documentation when nonpecuniary factors are considered, including the following: (1) why the consideration of only pecuniary factors was not sufficient to make the decision, (2) how the selected investment compares with the considered alternative(s) and (3) how the applicable nonpecuniary factor(s) is consistent with the interests of the participants and beneficiaries (which can include responding to participant demand).

While the documentation requirement may give plan sponsors pause, it is the author's interpretation that this framework still supports the use of ESG investment options in certain circumstances. One notable difference between the proposed rule from June on this issue and the final rule is the final rule's removal of heavy reference to ESG; the final rule instead distinguishes between *pecuniary* and *nonpecuniary* factors.

By taking such action, DOL seems to acknowledge that ESG is a broad, complex term that is not necessarily synonymous with nonpecuniary. In fact, the final rule acknowledges that ESG factors may be considered pecuniary under certain circumstances, providing the example that a fiduciary may prudently conclude that management diversity or a company's environmental record would have a material financial effect on the investment. This interpretation accommodates ESG integration, a practice increasingly used by investment managers to assess risk while maintaining a returns-focused strategy.

In addition, a plan fiduciary could determine that a fund with an ESG focus cannot be distinguished from reasonably available investment alternatives and may therefore utilize nonpecuniary factors (including participant demand) in the evaluation. To the extent the fiduciary can then show that the nonpecuniary ESG factor(s) being considered do not create additional risk or sacrifice return (or, alternatively, that the ESG factors do in fact have a material financial effect on the investment), the fund can be offered to participants.

On March 10, DOL's Employee Benefits Security Administration (EBSA) announced that it will not enforce the final rule until further guidance is published. A press release said EBSA plans to conduct "significantly more stakeholder outreach to determine how to craft rules that better recognize the role that environment, social and governance integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations."[8]

Evaluating and Selecting ESG Strategies

The recent DOL guidance is driven in part by the growing number of investment products labeled as ESG. According to Morningstar, 23 ESG strategies were launched in the first half of 2020. As investors continue to move away from active strategies in favor of low-cost indexing, some active investment management firms are using the ESG trend to accumulate assets and charge higher fees. A strategy can be labeled as ESG, but it may not adequately integrate environmental, social and governance factors into the investment process. This "green washing" of investment products is what DOL is seeking to limit, but it also creates a hurdle for plan sponsors by advocating for an additional layer of due diligence on these strategies. To assist in this endeavor, plan sponsors should seek guidance from their investment consultants, who should be well-versed in the best practices for evaluating sustainable strategies.

takeaways

- Over the last year, investment funds that integrate environmental, social and governance (ESG) factors have outperformed or produced similar results when compared with nonsustainable investments. These funds also have shown resilience in times of market turmoil.
- In October, the U.S. Department of Labor issued a final rule for retirement plan sponsors regarding the use of ESG factors in selecting investments. The rule requires plan fiduciaries to make investment decisions solely based on *pecuniary factors,* which may include ESG factors that are deemed financially material to the investment.
- The final rule still supports the consideration of nonpecuniary ESG factors in certain circumstances but will require plan sponsors to conduct additional due diligence and reporting when selecting such investments.
- Another hurdle faced by plan sponsors that are interested in adding sustainable strategies to their plan lineups is determining the scope of the strategy to align with participant interest.

For example, in addition to meeting the qualifications of a non-ESG strategy, it is important to adequately evaluate:

- **The team:** Does it include dedicated ESG analysts?
- **Investment philosophy:** How is ESG integrated into the risk analysis process?
- **Resources:** Is the strategy using proprietary research or relying on third-party ratings firms?
- **Reporting:** How is the strategy communicating the results of its endeavors to investors?

The reporting element has been a source of contention since different strategies rely on different metrics, making it difficult for investors and consultants to compare strategies and consolidate reporting across the portfolio. To address this problem, the United Nations' Sustainable Development Goals (SDGs) have emerged as a leading framework for reporting, serving as the "universal language" when incorporating ESG into the investment process at the company level (i.e., corporate responsibility), the asset manager level (e.g., ESG evaluation criteria) and the plan sponsor level (e.g., ESG considerations incorporated into the investment policy statement). The 17 SDGs displayed in the sidebar also include underlying goals and key performance indicators as a way to provide further guidance on implementing sustainable strategies.

The Sustainability Accounting Standards Board (SASB) also has developed industry-specific standards to assist asset owners in navigating ESG disclosures. The SASB framework focuses on financial materiality to determine which sustainability issues are likely to have the greatest impact on the financial condition or operating performance of a company, based on the industry subset. Plan sponsors can use this tool in distinguishing between pecuniary and nonpecuniary factors in compliance with the DOL guidance.

Another hurdle faced by plan sponsors that are interested in adding sustainable strategies to their plan lineups is determining the scope of the strategy to align with participant interest. ESG funds cover a broad landscape of issues. In addition to strategies that broadly integrate ESG issues into their risk analysis process, funds can target specific issues such as clean energy, water conservation, labor practices and diversity. One way that plan sponsors can determine how best to meet the needs of their participant base is through engagement. Investment consultants can assist in this engagement process by working with plan recordkeepers to draft and administer surveys that gauge participant interest in ESG and determine the specific areas of concern for participants.

United Nations Sustainable Development Goals

1. End poverty in all its forms everywhere.
2. End hunger, achieve food security and improved nutrition, and promote sustainable agriculture.
3. Ensure healthy lives and promote well-being for all at all ages.
4. Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all.
5. Achieve gender equality and empower all women and girls.
6. Ensure availability and sustainable management of water and sanitation for all.
7. Ensure access to affordable, reliable, sustainable and modern energy for all.
8. Promote sustained, inclusive and sustainable economic growth, full and productive employment, and decent work for all.
9. Build resilient infrastructure, promote inclusive and sustainable industrialization, and foster innovation.
10. Reduce inequality within and among countries.
11. Make cities and human settlements inclusive, safe, resilient and sustainable.
12. Ensure sustainable consumption and production patterns.
13. Take urgent action to combat climate change and its impacts.
14. Conserve and sustainably use the oceans, seas and marine resources for sustainable development.
15. Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, halt and reverse land degradation, and halt biodiversity loss.
16. Promote peaceful and inclusive societies for sustainable development, provide access to justice for all, and build effective, accountable and inclusive institutions at all levels.
17. Strengthen the means of implementation and revitalize the global partnership for sustainable development.

ESG Trends

Although challenges persist, the rise in sustainable investing may be an appropriate response to other macroeconomic trends. First, advances in technology have resulted in infor-

mation getting disseminated at a much broader and faster pace. This means that if there is some sort of ESG-related concern at a company, the market learns about it right away, and the scenario doesn't need to reach "disaster" level to meaningfully impact shareholder value.

Companies are recognizing that they may face significant reputational risk for not addressing sustainability issues head-on, so there has been an increase in sustainability reporting by companies in the S&P 500 Index, jumping from 20% to 86% over the past nine years.[9] The content of these reports continues to be analyzed by investors and priced into the market, and companies that refuse to take a transparent approach may fall behind. As investors, investment managers and companies prepare for the next black swan event, like the global pandemic or global financial crisis, concerns surrounding climate risk and racial inequality seem to be inevitable considerations.

Investors may also need to consider that corporate value is increasingly comprised of intangible assets. Forty years ago, the bulk of enterprise value within the S&P 500 was property, plant and equipment. Now, things like intellectual property, data and human capital make up more than 84% of S&P 500 firm value. This shift has been further accelerated by COVID-19 as reliance on technology has become a matter of survival for most companies. These intangible assets are seemingly difficult to assess using traditional financial metrics. As such, investors are turning to ESG factors as a way to further analyze corporate risk.

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Christopher K. Merker and Sarah W. Peck. 2019.
Palgrave MacMillan.
Visit *www.ifebp.org/books.asp?9155* for more details.

Coinciding with increased investor interest in the space, advances in technology have improved the reliability and abundance of data available to investors to better assess investment managers and companies from a sustainability perspective. This has allowed consultants to update their reporting to better serve plan sponsors and help them meet the documentation requirement set by DOL. Manager search books should include sustainability metrics, similar to traditional metrics used to assess an investment strategy, and reporting should also be available to provide further analysis of any ESG investment option selected.

Incorporating ESG

Following are steps that DC plan sponsors should consider when seeking to include ESG strategies in their investment lineups.

- **Educate the fiduciary decision makers.** ESG is a relatively new and evolving landscape that has yet to develop standards across the way it is termed, measured and reported. This can lead to an abundance of confusion. The plan investment consultant should be able to provide educational tools to navigate the terminology and provide guidance on implementation.
- **Be mindful of procedural prudence.** This ranges from incorporating ESG-related goals into the investment policy statement to documenting the investment decision-making process through meeting minutes, manager due diligence and participant surveys if applicable.
- **Ask questions during the manager evaluation process.** It's key that fiduciaries understand how ESG is incorporated, especially if they are relying on these factors being deemed pecuniary by DOL. Conversely, if looking at nonpecuniary factors, it's important to analyze the differences in traditional financial metrics such as return, risk, diversification and cost when comparing with non-ESG strategies.

Conclusion

The case for ESG integration continues to generate acceptance throughout the investment community, and many strategies may already be incorporating this level of risk assessment even if their products are not labeled as ESG. Similarly, there is an attempt by some managers to greenwash their product as ESG to accumulate more assets and charge higher investment fees. As plan sponsors navigate this trend,

investment consultants can serve as a resource to provide additional due diligence on these strategies, survey plan participants and monitor evolving best practices as this type of investing continues to take shape.

Endnotes

1. See www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds.
2. CoreData research.
3. eVestment research.
4. Serafeim (2020). "Social-Impact Efforts That Create Real Value." *Harvard Business Review.*
5. See www.morningstar.com/articles/988114/sustainable-funds-weather-downturns-better-than-peers
6. Morningstar.
7. Department of Labor; Employee Benefits Security Administration; "Financial Factors in Selecting Plan Investments," 85 Fed. Reg. 72,846 (November 13, 2020).
8. See https://www.dol.gov/newsroom/releases/ebsa/ebsa20210310.
9. Governance & Sustainability Institute research results.

bio

Linsey Schoemehl Payne is a managing partner for Marquette Associates, Inc., and has thirteen years of investment experience. She serves as the primary consultant on several client relationships and is vice chair of the firm's sustainable investing group and a member of the OCIO committee. She was formerly the general counsel and chief compliance office for the Illinois State Board of Investment. She holds a B.A. in political science from the University of Missouri-Columbia, a J.D. from the DePaul University College of Law and an M.B.A. from the University of Chicago Booth School of Business.

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