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Office of Regulations and Interpretations
Employee Benefits Security Administration, U.S. Department of Labor
Room N-5655
200 Constitution Avenue NW
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Attention: Financial Factors in Selecting Plan Investments Proposed Regulation

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I am a senior fellow in business and economics at the Pacific Research Institute (PRI). The mission of PRI is to champion freedom, opportunity, and personal responsibility for all individuals by advancing free-market policy solutions. Since its founding in 1979, PRI has remained steadfast to the vision of a free and civil society where individuals can achieve their full potential.

The Department of Labor has proposed amendments to the investment duties regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) to confirm the fiduciary responsibilities of plan sponsors. Specifically, the amendments clarify that "ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action."

I am writing in support of this clarification, which is both appropriate and necessary due to the growth in Environmental, Social, and Governance (ESG) investing.

Proponents of ESG investing claim that prioritizing ESG considerations will promote better financial returns and improve social outcomes – the quintessential win-win. Due to these claims, there is growing pressure for private pensions, which invest $10.7 trillion on behalf of nearly 140 million Americans, to prioritize ESG considerations.

If adopted, the clarification would ensure that private pensions do not let ancillary issues distract them from achieving their primary mission – securing the retirement for millions of Americans. This important role of the managers of private pension plans should be noted upfront. American workers rely on their pensions to ensure that their retirement is financially secure. If private pension plans fail to achieve this goal, then it is not an understatement to note that millions of Americans will suffer. Achieving this goal is the primary social responsibility of private pension managers.

Not only is providing a secure retirement the socially responsible action of fiduciaries, ERISA requires that private pension fund managers act "solely in the interest" (as Supreme Court Justice Benjamin Cardozo noted) of plan beneficiaries.

Despite this well-established obligation of plan fiduciaries, the proposed clarification is necessary due to the growth in ESG's popularity. Whether it is allocating the assets in defined benefit plans based on ESG criteria, or offering ESG funds to participants in defined contribution plans, ESG investment screens introduce unknown investment risks that have the potential to harm plan beneficiaries. These harms arise because there are several foundational problems with ESG.

As applied, ESG is a vague and contradictory concept

Due to the vagueness of ESG criteria, there is not one consistent definition of what constitutes an ESG-compliant investment – one organization's ESG star is another's laggard. As a result, firms and organizations that rate companies based on their commitment to ESG will often contradict one another.

Take Amazon as an example. The company recently raised its minimum wage to $15 an hour, which is a typical goal of ESG proponents. However, Amazon is also widely criticized for many issues, such as the company's impact on the environment. Due to these realities, an ESG fund that emphasizes governance could rate Amazon highly whereas an ESG fund that emphasizes the impact from a company's operations on the environment could rate the company poorly.

This discrepancy demonstrates that a company's ESG designation is inherently subjective, and may not necessarily convey the information that investors believe is being expressed.

ESG performance is difficult to measure and does not convey the same information as traditional performance measures

Due to these definitional ambiguities, the performance of different types of ESG investments will vary significantly depending on the explicit ESG strategy undertaken. For example, some ESG funds apply an exclusionary investment criterion that simply avoids companies engaged in specific business lines (e.g. fossil fuel companies).

It is not surprising that over the past several years a fund manager can abstain from investing in fossil fuel firms and still build a broad-based investment portfolio that financially outperforms the market. After all, as of April 2020, the performance of six stocks [Facebook, Amazon, Apple, Netflix, Google (Alphabet), and Microsoft, known as FAANGM stocks] drove "nearly one-quarter of the movement" in the S&P 500 index.[1]

Even if broad-based ESG funds outperform the market for certain time periods, this experience does not provide any information regarding how ESG funds that are pursuing explicit social or environmental objectives will perform relative to key investment benchmarks. It is clearly inappropriate to rely on the performance of broad-based funds that simply exclude specific sectors

[1] Jagerson J and Hansen W (2020) "FAANGM Stocks Are Driving the S&P 500 Higher" *Investorplace.com* April 30; https://investorplace.com/2020/04/faangm-stocks-are-driving-the-sp-500-higher/.

to justify investing pensioners assets in ESG funds that are pursing explicit objectives (e.g. funds that invest in companies with a disproportionate amount of women in upper management or funds that specialize in investing in alternative energy technologies).

However, there are reasons to be skeptical that ESG funds will outperform the market over the long-term. First, ESG funds tend to have higher costs associated with them. A review of 30 ESG funds I conducted for the Pacific Research Institute found that their average expense ratio was 0.69%, compared to 0.09% for a broad-based S&P 500 index fund.[2] It is common wisdom that high expenses meaningfully reduce investment returns.

Second, ESG funds tend to be riskier. The ESG funds I reviewed allocated 37% of their portfolio toward their top 10 holdings on average, compared to 21% for a broad-based S&P 500 index fund. The higher exposure to the top ten holdings means that the returns of ESG funds are more dependent on the performance of relatively fewer stocks. This concentration significantly reduces the benefits from diversification.

Third, my evaluation found no evidence that the ESG funds outperformed over the long term. Based on the funds with a full 10-year track record, and including the impact from management fees, a weighted average investment across the ESG funds would be 43.9% smaller than an investment in a passive S&P 500 index fund.

ESG investments can contain unidentified risks

Some of the risks associated with ESG funds are typically overlooked and may be difficult to convey to pensioners. To see these risks, consider the potential returns of a broad-based ESG fund that shuns fossil fuel investments, but holds the FAANGM stocks.

Since the FAANGM stocks have driven the market over the past several years, and the stocks of fossil fuel companies have generally underperformed the market, it is likely that such a fund performed well. As a consequence, the performance of ESG funds that shun fossil fuel investments may appear to improve the financial returns for plan participants.

While excluding certain investments may have enhanced results in the short-term, these trends could change. The caveat "past performance is not indicative of future results" is apropos.

The financial argument for shunning fossil fuel investments is that alternative energy technologies will continue to grow at the expense of fossil fuels. And, should oil demand fall off as ESG investors envision, the underperformance of these stocks will persist. In this case, ESG funds that exclude fossil fuel companies will continue to benefit. However, the projection that the future demand for oil will decline is far from certain, and there are many reasons to believe that oil demand will continue to grow for the foreseeable future.

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[2] Winegarden W (2019) "Environmental, Social, and Governance (ESG) Investing: An evaluation of the evidence" *Pacific Research Institute* May 22; https://www.pacificresearch.org/new-study-finds-esg-funds-underperform-broader-investment-funds-over-long-term/.

Besides fueling one-third of the world's energy needs, oil is an irreplaceable component of thousands of products that consumers use every day (all plastic products, for instance). Electric vehicle sales, which are supposed to be a major displacer of oil demand, still represent only 2% of global vehicle sales.

This is why the International Energy Agency's (IEA) declining oil demand scenario is just one of several possibilities. In the other scenarios, the IEA forecasts that global demand for oil will continue to grow for the next two decades. If oil demand does grow, then ESG funds that exclude fossil fuel companies will face an increased risk of financial underperformance. The ESG screen will, consequently, impose a cost on pensioners.

This example demonstrates that the ESG funds are assuming specific investment risks. A problem arises because these risks are often not clearly expressed to plan participants. Just as important, if investment managers are assuming these risks in pursuit of non-financial goals (e.g. global climate change), then they are violating their fiduciary responsibility – private pension fund managers are not acting "solely in the interest" of the plan beneficiaries as ERISA requires. The proposed clarification helps ensure that such a violation does not occur.

Many ESG funds do not execute on their stated principles

Another problem that has arisen is whether ESG funds are actually executing on their stated strategy. For instance, a 2019 Wall Street Journal article found that the portfolios of several ESG funds held a larger share of bonds issued by Saudi Arabia than non-ESG funds.

Not only does Saudi Arabia have large oil interests, which are typically eschewed by ESG investors, the country also has a terrible track record on social issues.[3] Greater exposure to both the oil industry and Saudi Arabia's economy is a violation of the criteria that guides most ESG funds and almost certainly contradicts the expectations of ESG investors who rightly believe that ESG funds are not supporting the economy of a country with one of the lowest human rights track records according to human rights advocacy groups.

This example also raises concerns with respect to the financial performance of ESG funds.

First, since some ESG funds are not faithfully executing on their ESG strategies, it introduces uncertainty regarding the studies that claim ESG funds can outperform non-ESG investment strategies. Do the studies that compare the relative performance of ESG funds exclude those funds who are failing to effectively execute an ESG strategy? And, how do you measure whether an ESG fund is effectively executing its strategy? Without effective answers to these questions, which have not been forthcoming, the actual impact from effective ESG criteria on investment returns is unknown. With respect to private pensions, this means that investments into ESG funds could be introducing unknown investment risks that violate their basic fiduciary responsibilities.

[3] Mackintosh J (2019) "Why Your Good Governance Fund Is Full of Saudi Bonds" *Wall Street Journal* November 26; https://www.wsj.com/articles/why-your-good-governance-fund-is-full-of-saudi-bonds-11574781431?mod=article_inline.

Second, the problem of ESG funds not faithfully executing their ESG strategy raises questions regarding the costs of executing and monitoring an ESG strategy. Since there is a problem of whether ESG funds are faithfully executing their strategies, perhaps the already inflated costs of managing an ESG fund are still insufficient. Either way, the problem of faithfully executing the ESG strategy increases the likelihood that ESG funds will have materially higher administrative costs. Basic finance theory consistently advises investors that they should avoid investments with large administrative costs because these costs substantially reduce their investment returns.

Social issues are contentious and will vary across plan participants

Social issues are by definition contentious and it is unlikely that all participants in a private pension plan will have the same views on these issues. As SEC Commissioner Hester Peirce noted in a 2018 speech "problems arise when those making the investment decisions are doing so on behalf of others who do not share their ESG objectives. This problem is most acute when the individual cannot easily exit the relationship. For example, pension beneficiaries often must remain invested with the pension to receive their benefits. When a pension fund manager is making the decision to pursue her moral goals at the risk of financial return, the manager is putting other people's retirements at risk."[4]

Put differently, because pensioners will hold divergent views on controversial ESG issues, the only shared interest of this diverse group of individuals is the financial performance of the pension fund. The notice, by clarifying that fiduciaries cannot sacrifice returns or increase risks when making investment decisions, ensures that this shared interest is what will drive the investment decisions of the pension fund managers.

Defined contribution plan managers must also adhere to their fiduciary responsibility

The proposed rule also contains beneficial clarifications with respect to ESG investments held in defined contribution plans. Two clarifications are particularly beneficial for workers and pensioners – the requirement that the ESG funds will not sacrifice returns for non-pecuniary considerations and the requirement that ESG funds cannot be either the qualified default investment option or part of this option.

Starting with the former, the prime responsibility of managers of defined contribution plans is to offer investment options that provide responsible alternatives with respect to the risk and return trade-off. The proposed rule clarifies that investment options that create unknown risks violate this fiduciary responsibility. To the extent that ESG funds offer equivalent risk-adjusted investment returns, then these options are permissible. Such an environment strikes the right balance – ESG funds that can live up to the slogan of doing well while doing good are available to plan participants, but those funds that expose people to excessive risks or inadequate returns are excluded.

With respect to the default option, research demonstrates that the default investment option materially impacts the investment choices of plan participants. Given the problems with ESG funds, such as the wide variability of ESG objectives, allowing ESG funds to be included in the default

[4] https://www.sec.gov/news/speech/speech-peirce-092118

investment options could encourage plan participants to hold ESG investments that are either inappropriate or not consistent with their individual investment goals.

Improvements to the proposed rule should address conflicts in the proxy process

Beyond the investment considerations, ESG initiatives are often considered at shareholder meetings. Legally, private pension fund managers must vote on these proposals. Often, fund managers turn to proxy advisory firms for advice regarding how they should vote.

The two largest proxy advisory firms (ISS and Glass Lewis) control 97 percent of the proxy advisory market. But, since these firms also provide ESG advisory services to corporations, the proxy advisors have a meaningful conflict of interest with respect to ESG programs that could be biasing their advice on shareholder resolutions. In fact, research by the Manhattan Institute found "a positive association between ISS recommendations and shareholder voting and a negative relationship between share value and public pension funds' social-issue shareholder-proposal activism (which is much more likely to be supported by proxy advisory firms than by the median shareholder)."[5]

In light of these potential conflicts of interest, the rule should be expanded to clarify that private pension fund managers cannot blindly follow the advice of proxy advisory firms. The rule can achieve this goal by requiring private pension fund managers to certify that they received a fully transparent report that details the expected impact from the proposed ESG program, discloses the methodology behind the analysis, and reveals any potential conflicts of interest that the proxy advisory firm may have. Without such assurances, private pension funds may be violating their fiduciary responsibilities when they adopt the ESG voting positions suggested by the two major proxy advisory firms.

Concluding thoughts

Faithfully executing their fiduciary duty is the primary social responsibility of private pension managers. The bedrock foundation of this responsibility is achieving the best risk-adjusted return for plan participants. The proposed rule clarifies this obligation and, in so doing, helps ensure that pensioners' hard-earned retirements are not unnecessarily jeopardized. The rule would be, consequently, an important improvement.

Sincerely,

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[5] Copland JR, Larcker DF, and Tayan B (2018) "Proxy Advisory Firms: empirical evidence and the case for reform" *the Manhattan Institute* May 21; https://www.manhattan-institute.org/html/proxy-advisory-firms-empirical-evidence-and-case-reform-11253.html.