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**Comment Letter on Rule Proposed by the U.S. Department of Labor,
“Financial Factors in Selecting Plan Investments,” June 30, 2020**

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Comment Letter Re: Department of Labor, Employee Benefits Security Administration, RIN 1210-AB95.

“Financial Factors in Selecting Plan Investments” Proposed Rule.

This comment letter responds to a request from the Employee Benefits Security Administration, U.S. Department of Labor, for comments on its June 30 proposed rule “Financial Factors in Selecting Plan Investments” (hereinafter the “Financial Factors” rule) focusing on “Environmental, Social, and Governance” (ESG) investing by private pension plans governed under the Employee Retirement Income Security Act of 1974.¹

My name is Benjamin Zycher. I am a resident scholar at the American Enterprise Institute in Washington, DC. I formerly was a senior economist at the RAND Corporation, an adjunct professor of economics at the University of California, Los Angeles (UCLA), and a senior staff economist at the President’s Council of Economic Advisers. I hold a doctorate in economics from UCLA and a master’s degree in public policy from the University of California, Berkeley. The views that I express in this letter are my own and do not purport to represent those of any institution with which I am affiliated.

Some recent related activities on my part are as follows. I submitted a comment letter to the Securities and Exchange Commission on the SEC Staff Roundtable on the Proxy Process (File No. 4-725).² I organized and moderated a panel discussion on “Environmental, Social, and Governance (ESG) Investing: The Proxy Advisory Process and the Interests of Investors,” held June 18, 2019 at the American Enterprise Institute, at

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¹ The proposed rule can be found at <https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments>. See also Eugene Scalia, “Retirees’ Security Trumps Other Social Goals,” *Wall Street Journal*, June 23, 2020, at <https://www.wsj.com/articles/retirees-security-trumps-other-social-goals-11592953329>.

² December 21, 2018, available at <https://www.sec.gov/comments/4-725/4725-4827804-177047.pdf>.

which SEC Commissioner Hester Peirce delivered the keynote address.³ Subsequent to that I submitted to the SEC a formal comment on the SEC Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (File No. S7-22-19).⁴

The new Financial Factors rule proposed by the Department of Labor is timely and needed, and the central purpose of this comment letter is the presentation of analysis in support of the adoption of the proposed Financial Factors rule as a final rule. Adoption of the rule is particularly important given the growing trend among fund managers governed by ERISA to incorporate ESG considerations in investment decisions. Such considerations must be heavily political, in particular because the choices among alternative ESG goals inevitably are arbitrary, and because the inevitable conflicts among them, and with the traditional and appropriate goal of value maximization, allow for no straightforward constraint on the ability of fund managers to use ESG factors to advance their own priorities. Thus does ESG investing conflict sharply with the interests of current and future retirees. Accordingly, investment decisions influenced by ESG considerations must carry with them serious adverse implications for the investment returns earned by current and future pensioners, that is, for their pecuniary interests.

The central importance of this proposed rule is captured well in section B summarizing the rule's provisions:

Paragraph (c)(1) directly provides that a fiduciary's evaluation of an investment must be focused only on pecuniary factors. The paragraph explains that it is unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal.

The proposed rule goes on to explain that:

The Department is concerned that the growing emphasis on ESG investing, and other non-pecuniary factors, may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defraying reasonable plan administration expenses. The Department is also concerned that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.

The ongoing drive for the inclusion of ESG factors in investment decisions by funds unquestionably is dominated by the purported evaluation of climate "risks," a concept that in the context of this proposed rule comprises two conceptually distinct imperatives:

³ A summary and podcast of the event are available at <https://www.aei.org/events/mutual-funds-public-employees-public-pensions-securities-social-justice-environmental-policy/>.

⁴ January 17, 2020, available at <https://www.sec.gov/comments/s7-22-19/s72219-6668654-203966.pdf>.

- The incorporation in investment decisions of a bias against investment in firms and industries that yield disproportionate emissions of greenhouse gases (GHG), whether directly or indirectly.
- The evaluation and disclosure of financial risks posed to a given firms by future anthropogenic climate change, assumed by the proponents of ESG investment constraints to be predictable within small margins of variation out to, say, the year 2100.

The Anti-GHG Bias. The issue to be addressed here is whether either of those imperatives is consistent with the fiduciary interests of current and future beneficiaries of pension and retirement funds governed un ERISA. With respect to the investment bias against the fossil-fuel industry and other such direct or indirect sources of disproportionate GHG emissions, the central reality to be recognized is straightforward: The imposition of an artificial constraint upon investment choices by definition cannot result in systematically improved financial returns to pension and retirement funds relative to a set of investment options not subject to such constraints. This is not merely an empirical observation; it is one driven by the eternal reality that a reduction in the investment options considered acceptable cannot improve overall investment performance.

That reality is clear in the evidence. Consider, for example, the effects of divestment from fossil-fuel producers. University of Chicago Law School emeritus professor Daniel R. Fischel found in a study that:

[Of the] 10 major industry sectors in the U.S. equity markets, energy has the lowest correlation with all others, followed by utilities---meaning that companies in these sectors provide the largest potential diversification benefit to investors, and that divestment would reduce returns substantially.⁵

A fact sheet released with the Fischel study notes that:

In particular, Professor Fischel's study tracks the performance of two hypothetical investment portfolios over a 50-year period: one that included energy-related stocks, and another that did not. The portfolio which included energy stocks generated average annual returns 0.7 percentage points greater than the portfolio that excluded them on an absolute basis and 0.5 percentage points per year higher on a risk adjusted basis. In other words, the "divested" portfolio lost roughly 50-70 basis points each and every year over the prior 50-years. Professor Fischel's study also found that ongoing management fees are likely

⁵ http://divestmentfacts.com/pdf/Fischel_Report.pdf

to be as much as three times higher for a portfolio divested of fossil fuel stocks.⁶

There has been extensive research on the question of the returns of ESG portfolios vs. broad index portfolios. For example, Adler and Kirtzman concluded in the *Journal of Portfolio Management* that “the cost of socially responsible investing is substantial for even moderately skilled investors.”⁷ A comparison published by the research firm MSCI found that \$100 invested in the MSCI KLD 400 Social Index, a popular ESG index, grew to \$338.08 for the 15 years ending Nov. 30, 2018. By comparison, \$100 invested in the MSCI USA Investable Market Index, comprising approximately 3,000 stocks across all market capitalizations (a proxy for the entire U.S. market), grew to \$369.84 – or 9.4% more.⁸ An analysis by Wayne Winegarden of the Pacific Research Institute concludes that:

Of the 18 ESG funds examined that had a full 10-year track record, a \$10,000 ESG portfolio (equally divided across the funds including the impact from management fees) would be 43.9 percent smaller after 10-years compared to a \$10,000 investment into an S&P 500 index fund. Further, only 1 of the 18 funds was able to exceed the earnings of an S&P 500 benchmark investment over a 5-year investment horizon, and only 2 of the 18 funds were able to beat the S&P 500 benchmark over a 10-year investment horizon.⁹

Additional analysis found that one of the oldest and largest ESG Exchange Traded Funds (ETF) yielded returns over 10 years 37 basis points lower than the S&P 500 index.¹⁰ Another analysis shows that for the five year period ending last May 15, Blackrock’s S&P 500 Growth ETF yielded average annual returns 10 basis points higher than those yielded by the Blackrock Clean Energy ETF.¹¹

The adverse effects of ESG investing are evident. Trustees of public-pension plans, for example, have ignored the explicit advice of financial advisors retained by the plans themselves so as to adopt ESG policies that reduce returns for millions of investors. In May 2017, for example, some members of the board of the \$25 billion San Francisco Employees Retirement System (SFERS) proposed divesting its portfolio of holdings of the 200 largest fossil fuel companies that comprise the Carbon Underground 200 stocks.¹² The board then asked its general investment consultant, NEPC Investment Consulting, to

⁶ <https://www.compasslexecon.com/compass-lexecon-releases-fischel-study-on-effect-of-fossil-fuel-divestment-proposals-on-university-endowments/>.

⁷ <http://jpm.ijournals.com/content/35/1/52>.

⁸ <https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6>.

⁹ https://www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf.

¹⁰ <https://www.bloomberg.com/opinion/articles/2020-01-27/esg-etfs-your-socially-conscious-fund-probably-has-some-holes>.

¹¹ <https://www.barrons.com/articles/blackrock-is-playing-politics-with-public-pensions-51590661589>.

¹² <https://mysfers.org/wp-content/uploads/08092017-board-meeting-07-fossil-fuel-A.pdf>.

analyze the consequences of such a divestment. SFERS staff examined NEPC's work and stated:

Retirement staff concurs with NEPC's conclusion that divestment from Carbon Underground 200 fossil fuel companies will materially reduce the potential risk-adjusted returns from the SFERS public markets portfolio.

Accordingly, the staff recommended against divestment.

In 2016, the California Public Employees Retirement System (CalPERS), the largest public-pension system in the U.S. with about 2 million members, similarly examined whether to continue a policy of blacklisting tobacco companies. Its financial advisor, Wilshire Associates, estimated that the policy had cost the system's members \$3 billion.¹³ In the end, the CalPERS board decided not merely to retain the ban on tobacco stocks but to broaden it.¹⁴

Such decisionmaking is reflected in the latest CalPERS announcement of its investment returns for the twelve months ending on June 30, 2020.¹⁵ The net rate of return on over \$389 billion in assets was 4.7 percent; but the net rate of return for public equity---stocks traded publicly---was 0.6 percent. The S&P 500 benchmark over that period delivered a rate of return of 7.5 percent, that is, 6.9 percentage points higher than that realized by CalPERS on its public equity portfolio.¹⁶ Can anyone believe that ESG investing had little to do with this vast underperformance?

Note that some of the examples above are public pension funds. The Financial Factors rule proposed by the Department of Labor appropriately applies to ERISA-managed private pension funds subject to ERISA constraints and requirements, as those funds are the focus of the Department's jurisdiction. But the evidence of ESG-related rate-of-return underperformance for CalPERS and other public pensions, and other investment funds as noted, demonstrates the larger reality of investment underperformance attendant upon ESG constraints. These examples offer central lessons for the importance of the Financial Factors proposed rule. Moreover, it would be appropriate for the Department of Labor to send guidance to state authorities to exercise similar regulatory oversight over public pension funds with respect to ESG pressures.

Some continue to argue that ESG investment constraints do not yield lower returns---or that they yield even higher returns---systematically.¹⁷ Consider ESG

¹³ <https://www.ft.com/content/e87a9b3c-0708-11e6-9b51-0fb5e65703ce>.

¹⁴ <https://www.calpers.ca.gov/page/newsroom/calpers-news/2016/votes-expand-tobacco-investment-ban>.

¹⁵ See "CalPERS Reports Preliminary 4.7% Investment Return for Fiscal Year 2019-20," July 15, 2020, at <https://www.calpers.ca.gov/page/newsroom/calpers-news/2020/calpers-preliminary-investment-return-2019-20>.

¹⁶ See U.S. dollar "Factsheet," in *S&P 500*, S&P Dow Jones Indices, as of July 20, 2020, at <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview>.

¹⁷ See e.g., <https://www.cnbc.com/2019/10/10/imf-research-finds-esg-sustainable-investment-funds-dont-underperform.html>.

investing that merely substitutes one ESG-favored set of companies (e.g., firms with small GHG footprints) in place of higher-GHG firms. Such a shift might mean that the artificial GHG constraint is small or non-existent; that is, that there is no meaningful constraint. An example might be a substitution of a technology company in place of an oil company. Because “ESG investing” has no straightforward definition, particularly in terms of constructing a portfolio, such investing can vary substantially in terms of firms and sectors.¹⁸ It is no surprise that some subset of ESG investments might yield higher returns than non-ESG portfolios over some time period, merely because of inevitable shifts in economic conditions. But that observation ignores the longer-term reality: An artificial constraint on investment choices introduces a bias in investment choices toward, in our example, firms with low GHG footprints. Such a bias cannot be consistent with value maximization yielding higher returns over the long run.

Financial Risks and Future Anthropogenic Climate Change. The evaluation of the future effects of increasing atmospheric concentrations of GHG is highly complex, and an examination of the scientific debate reveals sharp disagreement on the magnitude of the effects on a global basis.¹⁹ Such uncertainty is magnified greatly when “climate risks” are addressed on a regional basis, as the effects of increasing GHG concentrations will affect different regions differently, in ways understood poorly. The evaluation of such risks for individual firms is virtually impossible, that is, the statistical variance characterizing such estimates would be very high. Is it the position of the advocates of ESG investing that investment firms---even very large ones---are in a position to do such scientific and technical analysis of future climate phenomena, with resulting predictions that would support specific shifts in investments and the like? Or is it the goal of the proponents that a new class of consultants be created, whose predictions would add substantially to the uncertainties already face by given managements?

Even if such future climate effects were known with certainty, firms would have to evaluate the attendant impacts in terms of the market conditions---demand and supply shifts---that they would confront individually. Anyone attempting to predict shifts in future market conditions for a given sector or firms has an extremely difficult task; an attempt to predict the effects of one given factor among the myriad that are relevant is unlikely to prove viable. In short, the evaluation of climate risks is extremely difficult even on a global basis; it is nearly impossible for individual sectors or regions. Firms subjected to pressures to evaluate climate “risks” are in no position to do such climate analysis. This means necessarily that there will be a new market for the services of various proxy advisory firms and other such consultants, who will be in no better position to do climate analysis than anyone else, but whose recommendations will insulate

¹⁸ See James Mackintosh, “ESG Investing in the Pandemic Shows Power of Luck,” *Wall Street Journal*, July 15, 2020, at <https://www.wsj.com/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802>.

¹⁹ See, e.g., Collins, M., *et. al.*, 2013: “Long-term Climate Change: Projections, Commitments and Irreversibility,” in Stocker, T.F., *et. al.*, eds., *Climate Change 2013: The Physical Science Basis. Contribution of Working Group I to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change*, Cambridge University Press, Cambridge, United Kingdom and New York, NY, USA, at http://www.climatechange2013.org/images/uploads/WGIAR5_WGI-12Doc2b_FinalDraft_Chapter12.pdf; and the various discussions and debates at Judith Curry, *Climate Etc.*, at <https://judithcurry.com/>.

managements from accusations of ignoring those climate “risks.” Such ESG meddling in firms’ decisions cannot be salutary in terms of value maximization for current and future retirees protected by ERISA.

It is essential that the Department of Labor finalize and then enforce the Financial Factors rule. This is particularly important given the growing attempts, by many market participants and by those in a position to pressure firms, to use the resources of public companies to pursue goals inconsistent with value maximization for investors. Such goals inevitably must be politicized---no other outcome is possible---a deeply perverse set of constraints that even in principle cannot yield maximum (or most beneficial) return/risk outcomes for current and future retirees protected by ERISA. Value maximization will serve their interests, and by allocating capital toward economic returns higher rather than lower also will serve to create an economy larger rather than smaller, an outcome beneficial for all consumers.