Comment Letter on the DOL's Proposed Rule On Financial Factors in Selecting Plan Investments

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My name is Joe Kennedy. I am the President of Kennedy Research, LLC, and a former chief economist for the Department of Commerce. I am responding to the request for comments on the proposed rule by the Department of Labor's Employee Benefits Security Administration regarding financial factors in selecting plan investments.[1] The views expressed in this submission are mine alone and do not necessarily represent those of any other organization.

The Department's proposed rule serves as a valuable reminder 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." In other words, fiduciaries must always act in the interest of plan beneficiaries and never substitute their interests or values for those of their clients. This is especially true of advisors that manage company defined-benefit or defined-contribution plans. Unlike individual 401(k) and other plans, beneficiaries do not have the ability to choose their own advisors. This means that they are unable to take their money elsewhere if the manager fails to act in their interests.

However, the proposed rule's emphasis on the "all things being equal" test is likely to be ineffective. The Department is correct that it will be very rare for two possible investments to demonstrate "the same target risk-return profile or benchmark, the same fee structure, the same performance history, same investment strategy, but a different underlying asset composition." In such rare cases, the proposed rule's "break the tie" procedure is probably the wisest

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[1] *Federal Register*, June 30, 2020, p. 39113, RIN 1210-AB95.

course, although the required documentation will not provide an objective basis to evaluate the fiduciary's final choice.

Much more likely is the case where two possible investments have a number of different characteristics, including their environmental, social, and corporate governance (ESG) characteristics. As with most serious investment candidates, each prospective investment will be better on some criteria but worse on others, even without taking into consideration their ESG credentials. The proper balancing of these criteria will inevitably be a matter about which reasonable experts can disagree. Thus, the final decision will ultimately depend on the fiduciary's subjective judgment.

This limitation is inevitable because plan administrators and beneficiaries rely on investment advisors--precisely because the advisors' professional judgement is deemed to be better informed. These cases are much more difficult to audit because there is no objective standard to measure them by.

In this situation, a clear statement that ESG characteristics by themselves should not weigh into the fiduciary's evaluation of a potential investment is important. Of course, as the proposed rule states, these same factors may be considered if the fiduciary has a reasonable expectation that they will affect legitimate factors such as expected yield and risk. For instance, a fiduciary that believed a carbon tax was imminent and not already priced into the market could be justified in moving out of oil stocks and into cleaner technology. However, such a move would be difficult to justify if the government began to consider increasing subsidies for fossil fuel industries.

Although the Department of Labor has a limited ability to second guess the judgment of fiduciaries, there are some things it can do to increase the focus on traditional factors. One such action is the proposed rule's clear statement of the law's requirement that the fiduciary shall act "solely in the interest of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan…" In other words, it should commit to making long-term net returns the sole goal of the fiduciary.

Allowing fiduciaries to consider other, less-defined goals would soon become an excuse for poor performance. Since beneficiaries have a tough time monitoring

ESG goals or trading one goal off against another, they would be unable to effectively monitor fund performance. For instance, a recent news article shows that the diversity of ESG goals and grading systems and the vagaries of the market make it difficult to link short-term performance to investing goals.[2]

The heart of this rule is the requirement that the fiduciary

> [h]as not subordinated the interests of the participants and benefits in their retirement income or financial benefits under the plan to unrelated objectives, or sacrificed investment returns or taken on additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan.

Although beneficiaries may very well have interests that compete with maximizing yield, the fiduciary is not allowed to substitute his or her goals for them.

The Department could also protect beneficiaries by encouraging greater transparency regarding fund returns and expenses. This would make it easier for both fund administrators and beneficiaries to monitor fund performance and costs. The resulting competition should increase the performance of all funds.

Of course, it is not always possible to measure *ex-ante* performance by *ex-post* metrics. A financial advisor can sometimes increase short-term returns by taking on additional risk, even if beneficiaries are not fully compensated for the extra risk. Still, clear metrics of over a period of at least five years gives investors a good guide as to likely future performance.

The Department of Labor could also monitor the sales literature and marketing practices of ESG firms. It should be possible for a fiduciary or beneficiary to tell what criteria an ESG investment follows and how the attainment of ESG goals is monitored. Investors should be told how much they will likely sacrifice in yield in return for obtaining the ESG benefits.

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[2] James Mackintosh, "ESG Investing in the Pandemic Shows Power of Luck," *The Wall Street Journal,* July 15, 2020, https://www.wsj.com/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802?mod=itp_wsj&ru=yahoo.

Finally, the proposed rule's provisions regarding individual retirement plans do a good job of balancing investor returns with the desire to pursue ESG goals. The rule seems to allow plans to offer an ESG alternative only if it performed equally on all other relevant criteria. If interpreted too strictly, this requirement would effectively rule out any ESG fund. If interpreted too loosely, it would again fall well within the normal exercise of a fiduciary's professional judgement.

In order to maximize consumer choice while still protecting investors, the rule should allow a 401(k) investment plan *to offer* an ESG fund as one potential fund among many, provided that the fund's management verifies that it is pursues clear ESG goals and tries to maximize returns and lower costs given those goals and that both the goals and approach are clearly communicated to investors. As with all funds, the plan should periodically monitor performance.

The relatively low market share of ESG funds and the traditional investor's interest in net earnings make it unlikely that ESG funds will grow rapidly unless their long-term returns are comparable to non-ESG funds.

This approach maximizes investor choice while ensuring that ESG funds will still feel pressure to increase account returns. However, investors would be in a better position to make these choices if they had a clearer idea of precisely how ESG considerations will affect the plan managers' decisions. For example, will the plan automatically sell assets in a company that is currently experiencing a labor dispute or buy stock in a company that increases the minimum pay of its workers?

The rule correctly forbids an ESG fund from being used as a default plan. Given the importance of net returns to retirement income and the relatively small share of investment going into ESG plans, it is more reasonable to expect that an investor who fails to make an affirmative choice regarding her investments would favor increasing net returns over pursuing ESG goals.

The recent boycott of Goya over its CEO's praise of President Trump offers a good illustration of the perils that abound with ESG funds.[3] A fund manager pursuing ESG goals might sell Goya stock regardless of his opinions about its future value because of its endorsement by an unpopular politician who espouses views contrary to ESG precepts. A non-ESG fund might sell the stock simply because it

[3] Daniel Raisbeck, "Goya Boycott: Everything is Political Now," *Reason,* July 16, 2020.

believed the boycott will appreciably diminish the company's sales. A third fund might act similarly because it believed that growth in the retail food industry may diminish as Covid-19 cases decline and restaurants re-open. Although distinguishing these decisions *ex post* is likely to be difficult, investors should have a good understanding of which criteria will drive investment decisions.