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Financial Factors in Selecting Plan Investments

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General Comment

The various qualified retirement plans that fall under the guidance of ERISA via the DOL are a vital and necessary makeup of the average American's net worth. Workers across the country rely on these accounts to supplement their retirement, providing the dignity and independence that Americans deserve. Given this reliance and the relative size of these accounts as a portion of their net worth, the DOL's maxim regarding the protection of these beneficiaries should be with an eye towards inclusion versus exclusion. In other words, the DOL ought to allow plan fiduciaries to consider as many and any factors that maximize a participants' risk-adjusted return, all else being equal. These factors ought to be analyzed, held to scrutiny, and either struck down or assimilated. These should include ESG factors and any other factors that could materially improve the beneficiaries' risk-adjusted return. However, it's clear that, based on the below evidence, the DOL's proposed rule to prevent ESG-minded investments is driven by other considerations, and the elimination of ESG-factors may ultimately result in the very detrimental outcomes it desires to avoid.

The DOL's argument against the incorporation of ESG investments relies, in part, on an inadequacy of the terminology of ESG factors, and the way that they can be analyzed. Further, they DOL's new rule suggests that ERISA could be violated by fiduciaries agreeing to lesser outcomes as a function of offering ESG-considered investment options. They have also argued that ESG funds generally come with higher fees and therefore those fees could be a material drag on a participant's investment return.

Unfortunately, these arguments do not hold up to scrutiny, both with respect to counterexamples where the DOL has suggested the inclusion of investments where the same arguments could be applied, and also that they very arguments they give for not including ESG investments are based on evidence where there is a lack of consensus (by the DOL's own admission).

First, regarding the inadequacy of evaluating ESG factors and considerations. It is true that ESG is a newer concept, and it is also true that there are many difference definitions and permutations of this concept, including impact investing, socially responsible investing, etc. However, the comment conveniently does not include the breadth of progress that has been made on this issue. As it turns out, there are several firms, including Morningstar, MSCI, and others, who provide a uniform and systematic framework to evaluate these factors.

Then there is the argument where the DOL asserts that participants could be subjected to worse return in ESG investments, all else being equal. It is the case, like many other mutual funds, ETFs, and index funds, where some funds with ESG considerations underperform their non ESG-minded peers. However, it's also the case, and substantiated by research from Morningstar, among others, that some ESG investments (and in some cases, a majority, contingent upon how these investments are categorized) yield a greater return relative to funds that do not consider ESG factors. Why hasn't the DOL commented on these funds? It's clear they are cherry-picking data that only substantiates their assertion of underperformance.

Finally, the DOL makes the contention that ESG factor funds may result in lower returns since some firms have higher fees (in the form of greater fund expenses) relative to non-ESG funds. Whether these ESG funds are "active" mutual funds or ETFs, it is the case that some have higher expenses. However, it is also the case that many of these funds have a superior risk-adjusted return even factoring in these fees when compared to non-ESG funds. This seems to be an argument in favor of ESG factors, rather than the other way around.

Perhaps most damning is the fact that, only several weeks ago, the DOL proposed guidance on private equity as a component of plans which fall under ERISA guidance. Private equity has long been available only to institutional investors, and certainly not the average retail investor and relatedly, qualified retirement plans. The reasons for this exclusion include higher fees, investment complexity, a lack of transparency, and unknown risks.

How would the DOL square the fact that their main arguments against ESG investments could also be made against the inclusion of private equity in qualified retirement plans, yet are more inclined towards private equity?

They may point to the fact that private equity has more longevity in the marketplace and has become increasingly more mainstream. However, this is simply an argument of degree. It is also the case that ESG factors have become more mainstream. This argument does not also address the higher fees and the lack of transparency.

Attachments

MS Does Investing Sustainably Mean Sacrificing Returns March 2018

MS Sustainable Funds US Landscape Feb 2020