ESG Investing and ERISA Private Pension Funds comment by Todd Royal

Re: RIN 1210-AB95

INTRODUCTION

The U.S. Department of Labor (DOL) is proposing to amend the "Investment duties" regulation under Title I of the Employee Retirement Income Security Act of 1974, (ERISA) to confirm:

> "That ERISA requires 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 light of the proliferation of investment strategies tied to environmental sustainability, social justice, corporate governance and an array of mostly-progressive policy priorities covered under the term "ESG" investing, the Labor Department is wisely proposing new regulatory action. The proposed rule will ensure retirees are protected, workers are guaranteed prudent investment decisions, and financial growth is at the forefront of benefit plans covered by ERISA.

Environmental protection, workers' rights, and transparency are noble endeavors for sure and investors, more than ever, want goodness and virtue to flow into their portfolios. But ERISA is meant to enhance retirement savings plan performance so American workers can be financially secure in their later years, and not to use retirement savings to make social statements, or advance policy prescriptions.

No matter how admirable or sincere the proponents of ESG investing might be, politically-skewed investing tends to mean "taking on additional risk or choose(ing) lower-performing alternatives as a means of promoting social goals." Shareholder activism and fee structures that benefit some ESG funds are exerting tremendous pressure on asset managers to select ESG options. However, there are no consistent metrics for defining ESG investing. Priorities under that rubric are prone to shift based on fleeting public opinion and political debates. Most importantly, studies show ESG investments do not perform as well as non-ESG investments.

Allowing so much ambiguity, uncertainty, and risk is in direct opposition to the foundational principles of federal retirement income policy. ERISA became law in 1974 when a Republican President and Democratic-majority Congress came together "to promise workers their retirement savings would be managed with the utmost care." ERISA relies on the concept of fiduciary obligations that go back nearly a century. In 1928, Supreme Court Justice Benjamin Cardozo said fiduciary standards and behavior hold "the punctilio of an honor the most sensitive," meaning, people's hard-earned money without the whimsical, unclear notions that accompany ESG investing.

In the decades since its enactment, regulations and court decisions have strengthened ERISA's principles. Courts have held that ERISA section 404(a)(1)(A) have required fiduciaries to act in accordance towards investor loyalty, and have undivided attention in regard to their beneficiaries. Decisions must, "Be made with an eye single to the interests of the participants and their beneficiaries."

In 2014, the U.S. Supreme Court unanimously ruled that in the context of ERISA retirement plans – interests have never been understood to be social or environmental in their governance of investment decisions or policies. Such interests are definitively understood as "financial" rather than "nonpecuniary" benefits. Federal appellate courts seemingly have gone further in defining ERISA's fiduciary duties, as "the highest known to the law."

ERISA requires financial pragmatism and sagely diversifying portfolios to maximize investor and retirement plan gains. Its goal is to shield retirees and those saving for retirement from passing fads, such as companies like Enron or splashy environmental crusades that cause wild fluctuating and devastating losses in retirement plans.

Given the consequences for the collective holdings of $10.7 trillion in ERISA-regulated plans and the risk of undermining the obligations of fiduciaries, it is imperative to reinforce requirements and principles at this time. In short, the proposed rule advances President Trump's promise to put the interests of American workers ahead of virtue signaling.

CAVEAT EMPTOR: ESG INVESTING'S MANY FLAWS

ESG has gained traction considerably in the last ten years, but criteria used to evaluate companies and industries vary widely. This poses a challenge for comparing and contrasting the performance of funds tied to ESG investing.

In one survey of "socially responsible investing," Morningstar Financial Services Company tracked the phenomenon in 2018-19 and found a fourfold increase in the number of "sustainable" funds. Conventional funds from over 3,100 represented institutional investors and businesses went from a factor of 81 to 564. These entities are following the United Nations Principle for Responsible Investment. However admirable these broad precepts, the devil is in the details.

ESG investment metrics are poorly defined and contradictory. Researchers at the Massachusetts Institute of Technology's Sloan School of business analyzed six different methods of ESG rating providers use to find their approaches to investment success. Their findings revealed a wide divergence in how ratings are scored and what defines success. The absence of transparency and certainty makes it nearly impossible to withstand ERISA-based scrutiny.

In another comparison of two additional providers' rating systems, the firm Research Affiliates found a grossly wide gap in companies' scores. For example, Facebook received a highly sought-after environmental score from one provider, but a below-average score from the other. The 154 million American workers with holdings in savings plans covered by ERISA cannot afford to gamble with such inconsistency and uncertainty. This illustrates why this new regulation is needed, and ensure due diligence to fiduciary requirements is foremost in the minds of investment managers; and to limit what MIT termed, "aggregate confusion" using ESG for investment decisions.

Of course, what is known about ESG investing underscores the need for more DOL scrutiny and justifies the amplification of ERISA fundamentals and the tightening up on fund managers' discretion to invest monies in these funds. Wayne Winegarden of the Pacific Research Institute found ESG funds "produce 43.9 percent less than standard S&P 500 index funds." Other data show that funds following ESG principles are likely to trail non-ESG investing by ten percent or more. The reason for this anemic performance is hardly a surprise. ESG investing tends to snub proven winners, such as Warren Buffet's Berkshire Hathaway and Amazon. The potential portfolio growth ESG investing casts aside is astonishing, and directly works against the protections provided to workers under ERISA.

The largest investment management firm in the world, and an active proponent of the ESG movement – BlackRock – is not immune to lower returns in their ESG portfolio. In fact, it proves that ESG investing often means anemic returns. The firm's S&P 500 Growth ETF soundly beat its Clean Energy ETF by an average of more than 10 percentage points annually. Seemingly, BlackRock is gambling with pension funds and retirement accounts to raise its stature or perhaps to take in more money despite modest returns. Is it any wonder why this new regulation is needed to provide clear guideposts when the leading ESG fund is the iShares MSCI US ESG Select Social Index Fund (SUSA), which currently lags the S&P 500 index by 37 points over 10 years?

It is possible BlackRock, and other high-profile investment managers are employing ESG investment strategies, because they sometimes charge higher fees for these investments. Currently, BlackRock charges over 40% higher fees for its iShares Global Clean Energy ETF (ESG fund) compared to its iShares Core S&P 500 ETF, according to the Institute for Pension Fund Integrity (IPFI), using data from Morningstar. If companies are charging higher fees for lower growth, the Labor Department's proposed rule would identify and stop this duplicitous practice.

Discriminatory actions by firms like BlackRock stemming from an embrace of controversial climate change policies are posing challenges to the fiduciary responsibility of asset managers to put clients' and retiree's best interests first. If individual investors are willing to accept higher fees and risk lower returns, they are free to invest accordingly, but it is critical to make sure ERISA does not sanction this.

The integrity of ERISA is also under attack by activist investor campaigns to divert funds away from the industries and companies that the ESG movement disdains to those the movement praises. The Securities and Exchange Commission has finalized a rule on the role of proxy advisory firms in this process, and how to ensure proper public disclosure in how resolutions before shareholders and shaped and promoted.

Joseph Kalt of Harvard University has done groundbreaking research into the shareholder activist problem, and concurred these crusades do zero for shareholder value and enhancement of portfolios, but divert financial resources away from good governance and lower fees. Whether proxy voting is biased towards political and social action, results in higher fees for lower returns, or simply conceals political beliefs, the fiduciary has an obligation to understand the whole picture and present sound financial advice. The U.S.' pensions, private investment funds, and everyday shareholders expect maximized returns coupled with good governance under ERISA. Do-gooding should be left to non-profit and religious organizations.

While this rule doesn't explicitly have language outlawing this issue, ERISA fiduciaries should never incur expenses to fight for environmental or social causes. What the final rule should clearly state is this: ERISA fiduciaries should not take part in ESG-related proxy voting or shareholder activism especially if this activity diminishes value for beneficiaries. In other words, unless there are guarantees that proxy voting is not skewing decisions, the presumption based on solid evidence, is that proxy voting does have this influence. Caveat emptor is not enough. It needs to be stated in clear regulatory language that fund managers should be wary of imbalance and excess in how proxy firms operate in promoting political agendas with other people's money.

This trend toward exerting disproportionate pressure to divert investments to companies and industries that have the favor of progressive's smacks of an elitist impulse to dictate to the majority without adequate disclosure. The Spectrem Group polled retail investors and individual retirees in 401(k) plans and found they wanted "profit-maximizing strategies over social priorities," according to over 5,159 respondents. Unsurprisingly, Spectrum discovered when retail investors were asked to decide between "return-focused objectives and political/social objectives, 91 percent prefer maximizing returns."

In the end, sustained efforts by activist investors are attempting to sway corporate policies, investment portfolios, and retirement security with a political agenda sowing confusion. The proposed rule will help ensure participants in savings plans will not get co-opted into making political statements they did not sanction while losing out on portfolio growth.

ENERGY: A CASE STUDY ON PRACTICAL CONSEQUENCES

The energy sector provides a useful case study about why politically-oriented activist investing can lead to ill-considered policy choices. Furthermore, it's why public policy should not be made in ERISA-protected investment retirement plans, but through the ballot box and the deliberative work of government agencies.

ESG proponents have directed heaps of scorn at the oil and gas industry, and urged a shift in investments to wind, solar and other alternatives. This investment philosophy ignores the essential role oil and gas products in making daily life possible. An editorial the *Wall Street Journal* published in late April, "Big Oil to the Rescue!" explained that over 6,000 products come from a barrel of crude oil, some of which are literally saving lives.

In addition, even though COVID-19 has nearly brought the economy to a halt, natural gas has been a job-creating success story. On top of the job creation, as natural gas has replaced coal-fired power plants U.S. carbon emissions have fallen, lowering emissions 2.8% in 2019 alone. In addition, harnessing American energy reserves has helped the U.S. counter countries such as Russia and Iran from strengthening their geopolitical foothold in dominating international energy markets. In short, the U.S. shale revolution has helped create prosperity, reduced carbon emissions, and enhance American security.

A simplistic anti-fossil fuel mantra conveniently ignores realities that also ought to have a bearing on ethics-oriented investing. For example, solar panels and wind turbines often depend on rare earth elements sourced from countries that Amnesty International and the United Nations have deemed human rights disaster-zones.

In addition, the ESG presumption that it is viable technically and financially practical to convert to any other source other than oil and gas is utterly without foundation. Fossil fuels still power over 85% of global energy consumption according to the *British Petroleum Statistical Review of World Energy 2020*. ESG proponents of rejecting investment growth opportunities in traditional energy companies lack a viable alternative, or details of how it will be possible to build brand new electrical grids across the U.S. that fully incorporates wind, solar, and advanced, grid-scale battery storage to address chaotically, intermittent renewable electricity generation.

Finally, ESG investment orthodoxy in the energy sector glosses over complex questions such as how climate change expenditures by governments can actually hurt the world's poor. ESG zealots also fail to grapple with the fact that their values-based prescriptions overlook the fact that environmental degradation will continue to take place in China, India, and Africa where thousands of coal-fired power plants are currently being constructed, or how unconstrained birth rates will impact energy needs.

Such issues illustrate why making public policy and considering the economics and technical aspects of fossil fuels versus renewables, along with the needs of an ever-rising global population and global supply chains, should be debated in Congress with close consultation with the U.S. Departments of Energy and Commerce. Using retirement plans to make energy policy makes no sense and the Labor Department's proposed rule on ESG investing wisely seeks to curb this.

CONCLUSION

The popular trend of ESG reflects a willingness of some investors and asset managers to forgo income gains for a perceived public good. That is their right. However, social and policy preferences encompassed by ESG investing can change hour to hour, day to day, month to month and certainly year to year. This kind of investing presents a direct challenge to ERISA's purpose, which has always focused on the fiduciary duty to enhance the financial position of retirement savers.

For the limited ESG investing permitted in retirement plans covered by ERISA, regulations require the same vigorous analysis about trade-offs, and the economic and social benefits that non-ESG investing undergoes. In 2018, DOL took steps to clarify this process, and to curb abuses, close loopholes, and better protect savers in retirement plans under ERISA's jurisdiction. The proposed rule is a necessary augmentation of these and other steps to reinforce ERISA's fundamentals.

The proposal takes aim at ESG campaigns that march under the banner of "stakeholder capitalism," but too often mean lower returns for the most important stakeholders - average investors in 401(k) and other plans. Under this new rule, a 401K plan would have to disclose the social justice part of the fund, and its impact on retirement security.

The rule will check discriminating against industries such as oil and gas, and thwart attempts by activists to use working Americans' retirement savings to make complex and far-reaching policy on energy and other matters. ESG fund managers are free to put their clients' money on wind and solar farms, but ERISA-backed retirement accounts need to disclose to the unsuspecting plan participant the inherent weaknesses in both forms of energy to electricity.

Americans are living longer than social security ever imagined. This proposed rule will enhance the backstop of supplemental income-generating investing that social security desperately needs. The proposed rule will protect millions of people who have entrusted trillions of dollars in pension and retirement plans with the belief that ERISA protects their money from political influence and reckless speculation.

Implementation of this rule will bar no one from making investments linked to personal views and ideology. It will simply restate the fiduciary duty under the law to invest retirement money wisely while affirming the public's trust that the law will not allow their golden years to be subordinated to politics, virtue signaling activists, or operators who stand to make money from distorting investment decisions to suit their views.