

SUBMITTED ELECTRONICALLY

July 25, 2020

Office of Regulations and Interpretations,  
Employee Benefits Security Administration,  
Room N-5655,  
U.S. Department of Labor,  
200 Constitution Avenue NW,  
Washington, DC 20210

**Re: RIN 1210-AB95; Financial Factors in Selecting Plan Investments**

Thank you for the opportunity to comment on the above proposed rule, which would update prior Interpretive Bulletins on the consideration of environmental, social and governance factors by ERISA fiduciaries.

I welcome the Department's recognition of the growth of ESG investing, and of the importance of this trend. There are, however, a number of reasons to believe that the proposed rule as drafted would undermine, rather than enhance, participants' best interests.

The integration of ESG considerations into investment processes is likely to continue to expand for a number of reasons, not the least of which is that they are financially impactful, and I believe that the Department should withdraw the proposed rule and instead direct its efforts to encouraging a long-term and responsible mindset throughout the investment community.

In the detailed comments below I concentrate on three main points:

1. That the practical effect of the proposed rule would be to provide participants with minimal (if any) additional protection against inappropriate ESG-related activity, while at the same time causing significant harm by hindering appropriate activity.
2. That to assume that any attention to non-pecuniary objectives must necessarily involve a sacrifice of financial objectives is to impute to the portfolio optimization process a greater degree of power than exists in reality, because of the uncertainty in the inputs and the flatness of the utility curve.
3. That the global regulatory trend is supportive of ESG considerations and that, consistent with the efforts of other regulators around the world, the Department could play a valuable role in exploring ways that ESG objectives can appropriately be pursued without compromising participants' financial interests.

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## **The practical effect of the proposed rule**

The Department expresses concerns that the incorporation of ESG considerations into investment processes “– and especially a decision to favor the fiduciary’s own personal policy preferences – would raise questions about the fiduciary’s compliance with ERISA’s duty of loyalty.”

Fiduciaries take their responsibilities very seriously. Lawsuits against fiduciaries are common, and expensive. As a result, fiduciaries are extremely risk-averse when it comes to taking positions that deviate from common practice or that leave them exposed to challenge for other reasons. Indeed, even where such positions are in the best interest of participants, the potential for loss (which is always a possibility) means that the opportunity will often be foregone.

Furthermore, the existing regulations leave no doubt that fiduciaries may not compromise participants’ interests in order to pursue other goals. If the Department believes that there are cases of fiduciaries sacrificing the best interests of participants to advance other agendas, then the existing rules offer plenty of room to challenge those fiduciaries.

For these reasons, the proposed rule would in practice bring participants little if any additional protection against the inappropriate pursuit of ESG objectives by fiduciaries.

The proposal would, however, create a substantial bureaucratic barrier and potentially increased litigation risk for the growing majority of the industry who recognize that giving some regard to the quality of a company’s handling of matters like executive remuneration, board independence, pollution, child labor and much more is a basic element of investment due diligence.

The Department notes that “there may be instances where factors that sometimes are considered without regard to their pecuniary import—such as environmental considerations—will present an economic business risk or opportunity.” That is, to put it mildly, an understatement. The SASB Materiality Map<sup>1</sup>, for example, takes an industry-by-industry approach to identifying issues that are not included in traditional financial accounting yet are likely to materially affect the financial condition or operating performance of companies. Data security, for example, is identified as likely to be material for e-commerce and for some parts of the health care sector, ecological impacts as likely to be material for the extractives and minerals processing sector and the forestry industry, employee health and safety for the engineering, construction and mining industries, and so on. For every industry, multiple issues are identified as material.

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<sup>1</sup> <https://materiality.sasb.org>

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ESG analysis is not a bolt-on to true investment, it is at the heart of it. ESG issues have historically been underemphasized. This is, not least, a result of the difficulty of obtaining pertinent data and the absence of analytical tools, shortcomings that are beginning to be addressed, although there is a long way to go.

Further, as the Department notes, there are “important and substantial questions and inconsistencies” in this field. This is true, and when Frank Knight drew his famous distinction<sup>2</sup> between the well-behaved, measurable risk of the roulette table and true uncertainty (where the odds are unknown), he did so in order to make the point that it’s only true uncertainty, not tame well-behaved risk, that is a valid foundation for a theory of profit. ESG factors represent true uncertainty, which is why it is so important for investors to give them close attention. ESG analysis is essential because of – not despite – the fact that investors are dealing with incomplete data, with unknown and shifting relationships and with difficult-to-interpret science.

The materiality of ESG factors means that there would be a significant unintended detriment to plan participants should the Department create barriers to diligent analysis. The investment process must be free to consider all relevant information on an equal footing; there must be a level playing field.

The proposed rule would call out ESG factors as suspect, leaving fiduciaries open to challenge. Fiduciaries, as noted above, have a strong aversion to such situations because underperformance is always a risk for even the best investment strategies.

By placing a unique burden on the inclusion of ESG factors in investment analysis, the playing field would no longer be level. Not only would this undermine the quality of decisions, it could also hinder the development of better analysis, the continued improvements in our understanding of ESG factors, and the effective management of ESG-related risks.

Thus, far from the intended safeguarding against the risk of decisions “based on non-pecuniary factors without a proper analysis and evaluation”, the effect of the proposed rule in practice would be to shackle appropriate analysis.

### **ESG objectives do not need to come at the expense of financial goals**

ESG is a contentious topic because some of the factors it touches on relate to questions of values and the personal policy preferences mentioned earlier. There is, therefore, the opportunity to consider not only the financial effect of investment decisions but also the wider impact. Since the financial goals cannot be compromised, this is only appropriate in the context of a “tie-breaker” situation.

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<sup>2</sup> Frank Knight (1921) *Risk, Uncertainty and Profit* Houghton Mifflin Co., The Riverside Press.

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Regarding portfolio construction, the Department states the view that “true ties rarely, if ever, occur.” And, at first sight, it may indeed seem reasonable to assert that any attention paid to social or environmental goals must – even if only by a tiny amount – compromise financial ones.

After all, portfolio construction is, at heart, an optimization process. It’s about finding the mix of securities that has the highest utility or the highest risk-adjusted return or whatever other measure you like to use for the portfolio that is more likely to meet your financial goals than any other. It’s the highest point. And there’s only one highest point.

The highest point on a utility curve is not a Matterhorn-like sharp tip, though. It’s more like the top of a very gently rolling hill. I have appended an example of optimization at the end of these comments. In that example, moving 1% of the portfolio from stocks into bonds (or vice versa) reduces the risk-adjusted return of the optimal portfolio by one two-thousandth of one per cent. To describe that difference as immaterial hardly does its smallness justice.

One might respond that sub-optimal means sub-optimal whether the difference is one per cent, one two-thousandth of one per cent or one two-billionth of one per cent. However, investment is a social science, not a physical science. No model of the market is even close to precise enough to justify treating its output as anything other than one of many possible good answers. The inputs – which themselves are rounded in order to avoid spurious precision – are at best educated guesses and the uncertainty around them exceeds by a huge margin the loss of utility that results from small changes in the portfolio.

To assume that any attention to non-pecuniary objectives must necessarily involve a sacrifice of financial objectives is to ascribe magical powers to the portfolio optimization process, but these powers in reality do not exist. This is not to say that every portfolio is indistinguishable from every other. Rather, it is the case that for almost every portfolio, there are some economically indistinguishable alternatives.

That’s why no serious investor really believes that there’s a single right answer to the portfolio construction challenge. The situation described in the discussion whereby “after completing an appropriate evaluation, alternative investments appear economically indistinguishable” is not, as asserted, “rare” but rather is almost universal.

The scope to pursue environmental or social goals without compromising financial objectives is not unlimited, but it does exist. Environmental or social objectives do not necessarily have to come at the expense of financial goals.

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## **The global regulatory context**

Investment is a global activity. Interest in ESG has grown not only in the US but also in every other major financial market.

This has, naturally, engendered a regulatory response. Overwhelmingly, that response has been supportive. As the UN PRI have noted, “globally, there are over 730 hard and soft-law policy revisions, across some 500 policy instruments, that support, encourage or require investors to consider long-term value drivers, including ESG issues.”<sup>3</sup> Almost all of these were created in the past twenty years.

In taking a position at odds with this global response, the proposed rule therefore implies, in effect, not only that the market is wrong to embrace ESG considerations within mainstream investment processes but also that other regulatory bodies around the world are wrong to encourage this trend.

The global support stems not only from the view that a long-term responsible mindset is not harmful – and almost certainly beneficial – for end savers. It also reflects the broader duty of the regulator to structure markets to achieve the overall best outcome for society as a whole.

There is a growing awareness, both among regulators and among investors, of the central role played by the investment industry in the economy and in wider society. That role brings responsibilities. The investment process does not take place in a vacuum; investment decisions have impacts. There is a long list of actions that can be taken – whether by individual citizens, by corporations or by investors – that benefit them while imposing costs on others. These externalities are why we have laws and social norms against government officials accepting bribes, against companies polluting public lands, against investors laundering illegal drug money. These – and many other behaviors – are in one person’s best interest (in the short term at least) but detrimental to the overall good.

One of the most important things that regulators do is to minimize any misalignment between individual incentives and the wider good. For that reason, most regulators globally are welcoming and encouraging of a long-term responsible mindset among investors.

This makes it disappointing to see that the Department “does not believe that investment funds whose objectives include non-pecuniary goals—even if selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)—should be the default investment option in an ERISA plan”.

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<sup>3</sup> UNEP FI and UNPRI (2019). *Fiduciary Duty in the 21st Century* Final Report, p13.

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A different approach, one that is more consistent with the global context, would take a starting point of “if it’s possible to fully look after investors’ interests while also playing a positive role in the broader social good, we’re all for it.”

There are echoes here of an old argument about whether, as Milton Friedman argued, “the social responsibility of business is to increase its profits”<sup>4</sup>, no more and no less, or whether (as most now believe) there’s more to it than that. As Peter Drucker put it “any institution exists for the sake of society and within a community. It, therefore, has to have impacts; and one is responsible for one’s impacts.”<sup>5</sup> Drucker, to be clear, was not against making money. He was simply recognizing the wider context in which money is made.

Just as it is possible for corporations to be responsible for their impacts without sacrificing their desire to make profits, the investment industry, too, can acknowledge the impact of its decisions. This must, of course, be done within the context of the fiduciary duty to participants. There is an extra layer of complexity in the application of Drucker’s principle (that one is responsible for one’s impacts) when decisions are being made by one party on behalf of another. The principle is not, however, negated.

Given the growing importance of this topic, the Department could play a valuable role in exploring ways that ESG objectives can appropriately be pursued within the context of fiduciary duty, just as other regulators around the world are doing.

## **Background**

The comments above are my personal perspective, based on over thirty years professional experience of working with institutional investors as an actuary and investment consultant, including leading the investment consulting practices of Russell Investments in both the UK and the US, as well as the research team of Willis Towers Watson’s Thinking Ahead Institute. Today, I advise investment organizations on best practice in ESG and sustainable investing.

I would of course be happy to expand on any of the points above.

Sincerely,

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<sup>4</sup> Milton Friedman (1970) *The Social Responsibility Of Business Is To Increase Its Profits*. The New York Times magazine, Sep 13.

<sup>5</sup> Peter F. Drucker (1973) *Management: Tasks, Responsibilities, Practices*. Harper & Row.

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## Appendix: Example of portfolio optimization

The following example is an optimization exercise at its most basic. It is based on historical average returns, standard deviations and correlations of US stocks and US bonds, using the data of Aswath Damodaran of NYU Stern at [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/histretSP.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html). This data covers the 90-year period 1928-2019:

Stocks: 9.55% a year return, with a standard deviation of 19.49%.

Bonds: 4.89% a year return, with a standard deviation of 7.67%.

Stock-bond correlation: -0.01.

Under these assumptions, a portfolio consisting of 60% stocks and 40% bonds has an expected return of 7.69%, and an expected standard deviation of 12.06%.

To optimize the portfolio, we also require a risk tolerance parameter to define the desired trade-off between risk and return. If we set that parameter to .8785, for example, we can calculate the utility, or risk-adjusted return, of the 60/40 portfolio as:

$$.0769 - .1206^2 / .8785 = 6.03\%$$

It can be shown that any other portfolio mix produces a lower expected risk-adjusted return. If, for example, 5% of the portfolio were to be moved from one asset class to the other, the utility of the portfolio would fall to 6.02%. If stocks are the overweight asset class, then both risk and return are increased. If bonds are overweight, both risk and return are decreased. In either case, utility falls.

Hence, under these return assumptions, the 60% stock/40% bond portfolio turns out to be optimal for an investor with that particular risk tolerance.

The key point here, though, is that in order to reduce risk-adjusted return by one-hundredth of one per cent, we have had to move fully 5% of the portfolio between stocks and bonds: fundamentally different types of asset. If we were to move 1% of the assets, the loss of utility would amount to just one two-thousandth of one per cent.

Meanwhile, the assumptions themselves contain margins of error many times larger than this. The return assumptions were rounded to one hundredth of one per cent in my example; even that level of precision is in fact unjustified. And if we were to base our return inputs on the data history up to 2018 rather than 2019, then the average return on stocks would decrease by .22% and on bonds by .05%. In other words, the margin of error in our return assumptions far exceeds the loss of utility that is caused even by a material shift in asset allocation. Similar statements could be made

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for the standard deviation and correlation assumptions. And the margin of error in the risk tolerance assumption is, if anything, even larger.

The example is a simple one, and actual portfolio construction processes involve a considerably greater number of inputs and more complex assumptions. None of those additional complexities alter the key observation that the high point of a utility curve is, by its very nature, flat.