



ESG Investing and Fiduciary Concerns

By: Dan Cassidy, FSA, CFA®

The responsibilities of being a fiduciary of an ERISA-qualified 401(k) plan run the gamut from tax filings, auditors, communications and education to selecting the investments to offer plan participants. Over the years, fiduciaries have had to deal with a litany of investment fiduciary issues – 404(c) compliance, introduction of target date funds, qualified default investment alternatives (QDIAs) safe harbors, and/or money market funds “breaking the buck.” Basically, there’s a never-ending stream of decisions that fiduciaries must deal with in the best interests of the plan participants.

Now, in 2017, plan fiduciaries are facing a new issue. And it’s not coming from some anonymous government agency, but rather being brought up by plan participants who ask, “Can the assets in our 401(k) plan have a positive social or environmental impact?” The investment industry now uses the term “ESG” – which stands for Environmental, Social and Governance – to describe investments that utilize ESG factors in their investment decision-making process.

This question, and others like it, have been asked before. The US Department of Labor (DOL), which is the responsible agency for fiduciary questions like this, has issued guidance in the past.

Dan Cassidy, FSA, CFA® is a senior advisor at P-Solve LLC, part of the River & Mercantile Group. In over 25 years working with plan sponsors, Dan has specialized in cutting-edge approaches to risk management. Integrating investment, actuarial and fiduciary advice, Dan works with plan sponsors to maximize the effectiveness of their retirement programs. Dan authored *A Manager’s Guide to Strategic Retirement Plan Management* published by Wiley. He has served on the Board of Directors of the Society of Actuaries where he previously served as the chair of their Education System. In 2014, Dan and others were awarded a patent for a defined contribution default benchmark.



HOW DO ACTIVE MANAGERS DO THEIR JOB?

In general, all active managers – even those who do not consider themselves “quants” – start their investment process with a quantitative analysis of the investable universe. This analysis (of which basic versions are available through your retail broker, e.g., Schwab, TD Ameritrade), provides a scoring on a variety of factors. The “art” of active management is to use these scores plus the manager’s insights into markets on future trends, demographics, etc., to select investments expected to outperform a particular benchmark that the manager is trying to beat. Since all we know for certain are the past and current market price for a security, managers are basically trading securities back and forth based on the firm’s expected future earnings.

However, this past guidance was unclear at best, and prohibitive at worst. However, recent (2015) DOL guidance has provided a clearer pathway for fiduciaries who want to add ESG funds to their 401(k) line-up.

This article will describe today’s ESG funds, discuss the history of the DOL’s evolving views, and provide a general overview of ERISA fiduciary duty. Finally, we will bring it together and provide a framework for fiduciaries to follow if they would like to add ESG funds to their line-ups.

What is ESG investing?

Environment, Social, and Governance. Quite a mouthful. This is the most widely used term now in use to describe an investment strategy that utilizes qualitative factors beyond simple financial metrics to make informed active management decisions. Some of the most frequently used ESG factors are listed below.

- Environmental issues: Carbon emissions, water management, waste management, deforestation, air and water pollution, energy efficiency and energy mix.
- Social issues: Labor practices, human rights, community involvement, diversity, data protection and privacy, customer satisfaction and animal welfare.
- Governance issues: Management structure, board structure, compensation policies, political contributions, risk oversight and shareholder engagement.

Using non-financial criteria to evaluate an investment has a long history. At least since the 1950s, trade unions have used their pension plan assets to invest in projects that would benefit their members. The US DOL has called these types of investments economically targeted investments (ETIs) – more on them later.

In the 1970s, asset owners faced calls for disinvestment in South Africa due to the apartheid regime. Many mission-based organizations, e.g., churches, also used disinvestment principles to express their beliefs through exclusion of investments in certain “sin stocks,” e.g., gambling, liquor, guns, tobacco and sex-industry. “Socially Responsible Investing” and “Green Investing” were terms used to describe various themes used to screen stocks. As with many trends in the investment industry, an index was born that legitimized this style of investing. Initially called the Domini 400 Social Index, it’s now known as the MSCI KLD 400 Social Index. In 2006, even the United Nations got in the game with the launch of the Principles for Responsible Investment (PRI), which was a partnership of two UN groups – the UN Environmental Programme Finance Initiative and the UN Global Compact.

What does it mean to do ESG investing?

Investment managers following ESG principles are using ESG factors to provide additional insight into the future performance of a stock – see sidebar on active managers. The thesis goes

something like this: If Company XYZ is addressing ESG issues in its day-to-day business better than its competitors, we would expect Company XYZ to outperform its competitors. Compare this to prior iterations of ESG, historically using the name Socially Responsible Investing (SRI). SRI typically was a binary decision –

- If a firm was considered not responsible, then its allocation in a fund was zero (0) percent.
- If a firm was considered responsible, then its allocation in a fund would be determined by other typical active management factors.

This was a very heavy-handed method of selection – either in or out. Modern versions of SRI have integrated ESG factors in a more nuanced manner, providing active managers with a fuller picture of how to allocate capital in their funds.

Evolving Department of Labor viewpoint

Like most things affecting ERISA-qualified plans, most fiduciaries take a very cautious posture regarding new developments. To use computer software analogy, most fiduciaries are not “early adopters.” Typically, fiduciaries look for regulators to define the playing field, where the out-of-bounds lines are, for example – and then most fiduciaries look to stay far inbounds. Regarding ESG, the playing field was not very well defined, so much so that most fiduciaries stayed far away from playing

in this area at all. Now, since 2015, the DOL has clarified the situation, so most fiduciaries should feel comfortable when considering adding ESG funds to their line-up.

Why the confusion?

The Department of Labor’s views – or at least the perception of its views – have changed over time, from openly discouraging fiduciaries from considering such investments in 2008 to a more welcoming tone in 2015. Even back in 1994, the DOL, struggling to provide a clear picture of its views on the subject, felt it necessary to publish an Interpretive Bulletin (94-01) “to correct a popular misconception ... that investments in ETIs are incompatible with ERISA’s fiduciary obligations.”

With this context in mind, you can understand why fiduciaries are extra cautious when deciding whether to add ESG funds to their line-ups – let alone whether they should serve as the default option for a 401(k) plan.

Note: There is little, if any, case law concerning these issues to help guide fiduciaries’ actions. The only insight comes from Interpretive Bulletins (IBs) discussed later. IBs provide a view of the current administration’s viewpoint on topics – like ESG investing – but are subject to changes of opinions that naturally come from changes in administrations. As with all things relating to fiduciary compliance, we would recommend you seek the advice of qualified ERISA legal counsel.

Interpretive Bulletin 94-01 (IB 94-01)

Again, this IB’s stated objective was “to correct a popular misconception ... that investments in ETIs are incompatible with ERISA’s fiduciary obligations.” IB 94-01 explained how a fiduciary should evaluate a possible investment in an ETI. Basically, if an ETI had an expected return with similar risk to an alternative investment, then the fiduciary could select that ETI – provided it met diversification and other investment criteria applicable to the plan. Some practitioners have called this standard the “all things being equal” test. This IB has been the backbone supporting trade unions using ETIs in their pension plans.

Interpretive Bulletin 2008-01 (IB 2008-01)

Fourteen years later, the DOL issued IB 2008-01, which sought to clarify its position on ETIs.

ETIs were typically brought up by multiemployer plans (MEPs), e.g., a MEP covering the construction industry in a certain part of the country. IB 2008-01 cited a specific example where a MEP wanted to make an investment in a project that would provide jobs to their participants. Even though the investment provided a market rate risk and return profile, the plan already had other investments in the local area and this new investment would increase its concentration risk – thus exposing the plan to a possible large loss due to

lack of diversification. IB 2008-01 cited this increased concentration risk as the reason why the fiduciary may NOT choose this investment.

IB 2008-01 also addressed adopting an investment policy that uses environmental criteria – “green screens.” It warned fiduciaries that they could not “simply consider investments only in green companies.”

They said that fiduciary consideration of non-economic factors should be “rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA’s rigorous fiduciary standards.” This language was interpreted by most everyone involved in ERISA plans as essentially prohibiting investment in ESG-type funds and projects. Some believed this IB set a “higher and unclear standard” for fiduciaries reviewing ETIs.

Interpretive Bulletin 2015-01 (IB 2015-01)

With the gaining traction of ESG funds within the investment universe, and research showing that ESG factors often improved investment results, the DOL looked to revisit the issue in 2015. This IB was also the first one to specifically mention ESG factors (in addition to ETIs).

Since 2008, the DOL believes that it “unduly discouraged fiduciaries from considering ETIs and ESG factors.” Specifically,

1. Pursuing investment strategies that consider environmental, social and governance factors, even when they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and
2. Investing in ETIs even where economically superior.

So the DOL withdrew IB 2008-01, reinstating IB 94-1.

From a fiduciary standpoint, one could argue that the DOL was flip-flopping on this issue. To make sure not to have any misunderstandings, the DOL spent more than two pages on just the background in IB 2015-01, with the actual effective language taking up only about half a page. Clearly, the DOL did not want any misunderstandings this time around, and wanted to reiterate the core fiduciary standards within ERISA with the following language.

- The focus of plan fiduciaries on the plan’s financial returns and risk to beneficiaries must be paramount.
- Fiduciaries may not use plan assets to promote social, environmental, or other public policy causes at the expense of financial interests of the plan participants.
- Do not permit fiduciaries to sacrifice the economic interests of plan participants ... in order to promote collateral goals.

The DOL also emphasized that it has consistently recognized that fiduciaries could consider “collateral benefits” as tie-breakers – harkening back to IB 94-01’s “all things being equal” test.

With all this background, the DOL goes on to address ESG, providing fiduciaries with a road map to complying with ERISA fiduciary standards.

First, the DOL recognizes ESG as a possibly reasonable investment strategy (bold emphasis added):

Environmental, social and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, **such issues are not merely collateral considerations or tie-breakers, but proper components of the fiduciary’s primary analysis** of the economic merits of competing investment choices.

Second, the DOL distinguishes ESG from prior exclusionary/disinvestment strategies and accepts that ESG can form part of a reasonable overall investment strategy:

... if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including ... ESG factors, the fiduciary may make the investment without regard to any collateral benefits ...

Thirdly, the DOL attempts to remove the perceived stigma attached to ESG due to prior DOL guidance:

Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors.

Finally, since fiduciary standards emphasize process over results, the DOL clearly states that fiduciaries should use their normal procedures to review ESG investments.

... the Department does not construe consideration of ETIs or ESG criteria as presumptively requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.

For completeness, the DOL also included language applicable to 401(k) plans looking for 404(c) compliance. Basically, this stated that these four standards applied as well.

ERISA Fiduciary Standard Regarding Investments – Overview

General Fiduciary Rules

Any fiduciary of an ERISA plan – whether it is a traditional pension plan or a 401(k) plan – is subject to ERISA fiduciary standards. The four principles of ERISA fiduciary standards are:

1. Act solely in interests of participants and beneficiaries for exclusive purpose of providing benefits and defraying reasonable expenses.
2. “Act with care, skill, prudence and diligence ... that a prudent man ... familiar with such matters would use” – sometimes called the “Prudent Expert” rule.

would not be held responsible for individual participant elections. There are significant requirements for compliance with 404(c) and most providers can help fiduciaries ensure they are in compliance.

Qualified Default Investment Alternatives (QDIA)

With the passage of the Pension Protection Act of 2006 (PPA), plan sponsors can now designate a default fund(s) – a Qualified Default Investment Alternative (QDIA) – for those individuals who do not make an active investment election. If fiduciaries pick a QDIA, then the fiduciaries would not be held

ESG-BASED STRATEGIES HAVE KEPT PACE OVER TIME (11/1/09–4/30/17)¹



3. Diversify investments so as to minimize large losses.
4. Act in accordance with plan documents.

In the past, most fiduciaries (and investment consultants and advisors to the fiduciaries) would respond with the usual Investment 101 answer – any time you restrict or limit the investment universe for an asset manager, you reduce the possible investment return opportunities – particularly on the upside. However, recent research is now drawing a different conclusion.

Participant-directed 401(k) Plans

Fiduciaries have an additional safe harbor in ERISA 404(c), which states that if they comply with these rules, then fiduciaries

responsible for participants who do not make an active election. Again, as with 404(c) compliance, there are significant requirements in picking a QDIA. Most fiduciaries are picking a target date fund series that uses a participant’s age as the key variable for selecting a default fund.

Both 404(c) and QDIA regulations hark back to the original fiduciary standards of ERISA from 1974 emphasizing diversification and avoiding large losses as well as process over results. For any fiduciary looking into ESG funds, we would highly recommend following a due diligence process just as with other investment decisions fiduciaries have made in the past.

¹ MSCI: Can ESG Add Alpha?, June 2015 paper <https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169>

Fiduciary framework

So where does this leave the fiduciary when considering ESG funds for a 401(k) plan?

Since most, if not all, 401(k) plans avoid ETIs through direct investment, we will focus solely on adding ESG fund options to a 401(k) line-up.

As a first step, if you as fiduciaries do not want to do the due diligence to review ESG options, and still want to add ESG funds, probably the best course of action is to simply add a brokerage and/or mutual fund window. This would appeal to your participants who want to direct their investments in this manner while relieving the fiduciaries of direct oversight.

On the other hand, for fiduciaries willing to engage on this issue, by all means include ESG funds in your due diligence process. In fact, you will be joining a fast-growing group – according to the UN's PRI, asset owners with more than \$16 trillion as

well as more than 150 asset managers have signed up to their PRI Principles. Here's a quick list of things to consider as you review ESG for 401(k) plans:

- Look at your current options. You may be surprised by what you already have in your plan. Some managers may already have included some ESG concepts unbeknownst to you.
- Watch out for ESG funds that use indices/benchmarks that are solely made up of other ESG-type funds. If so, you will need to do significant due diligence to ensure compliance with the newest DOL guidance.
- Dig deeper – beyond the one-page fund fact sheet. How significant is the commitment to ESG principles?
- Default option/target date funds – no reason why you should limit your review to simply stand-alone options.

As with everything involving fiduciary responsibility, a key compliance concept to reiterate is establishing a process and documenting that process. This applies equally well for ESG options. Everyone, including the DOL, understands that an investment may not achieve the desired outcome – the very definition of risk! So fiduciary rules are not backward looking – they don't say, if an investment goes bad, you made a wrong decision. On the other hand, fiduciary rules say – with the information you (or your advisors) know today, is this investment prudent? And just as importantly, are you monitoring the effectiveness of these investments? Documenting a prudent process, both in the initial selection and through ongoing monitoring, will help insure compliance with fiduciary rules.

When selecting a target date series, plan sponsors spend most of their time on the asset allocation glide path and overall performance of the fund family – and rightly so. Most fiduciaries do not dig very deeply into the underlying funds that make up the actual target date fund, assuring themselves that “if the overall asset allocation is OK and overall performance is OK, I don't need to dig any deeper.” However, with proprietary target date series that come from one investment family, you are also selecting the style bias included in that firm. For example, a leading provider of target date funds has a significant growth bias for all of its equity portfolios.

There really is no difference in selecting an ESG target date fund – it has an ESG bias.

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