Memo on US DOL Bulletin Regarding ESG Investing

This past April, the US Department of Labor (DOL) issued Field Assistance Bulletin No. 2018-01, which provides guidance to plan fiduciaries as it relates to ESG Investment Considerations and Shareholder Engagement Activities. While this bulletin has garnered a lot of coverage, and has been viewed by some as being limiting for ESG-minded investors, the bulletin's guidance is not as controversial as it would seem at first glance.

ESG Investment Considerations

At the center of the concern is the DOL's statement on fiduciaries' obligations as it relates to the management of investments:

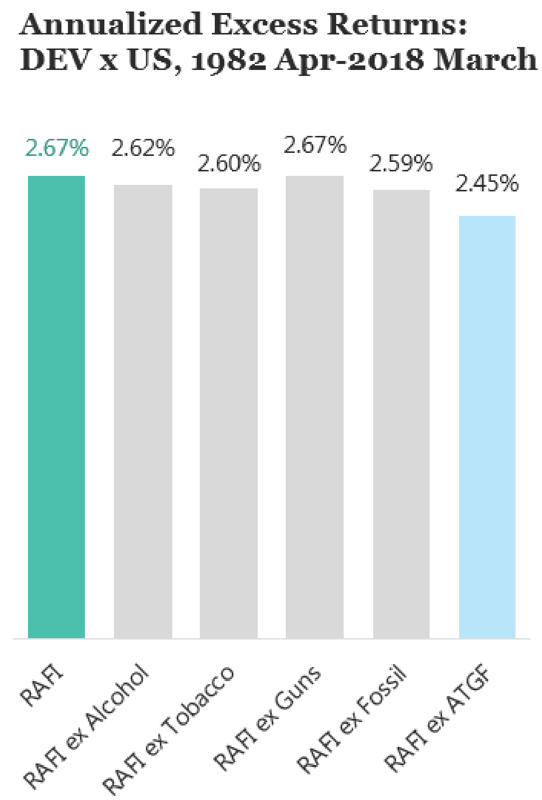
> …because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals.

This does not necessarily mean that the DOL is attempting to restrict ESG investing. The DOL further clarifies its remark by stating:

> …when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice.

It is our view that ESG investment strategies do not necessarily require sacrificing investment return or taking on greater investment risk. **Exhibit 1** illustrates the results of several naively constructed fundamentally weighted ESG strategies that exclude certain controversial industries: alcohol, tobacco, guns, fossil fuels, and all four industries combined. In both the US market and the developed markets ex US, excess returns for the exclusionary strategies are not meaningfully different from the fundamentally weighted portfolio. Far beyond being a tie-breaker, a thoughtfully designed, smart beta index strategy that incorporates ESG themes can deliver on the dual objectives of excess returns versus the market benchmark and social responsibility.

Exhibit 1:



Source: Research Affiliates, LLC, using data from Datastream and Worldscope.

Shareholder Engagement Activities

The second portion of the DOL bulletin deals with shareholder engagement activities. Similar to its statement on ESG Investment Consideration, the DOL takes the view that shareholder engagement can be undertaken as long as it adds economic value and is not excessively costly, stating as follows:

> …an investment policy that contemplates engaging in shareholder activities that are intended to monitor or influence the management of corporations in which the plan owns stock can be consistent with a fiduciary's obligation under ERISA, if the responsible fiduciary concludes there is a reasonable expectation that such activities (by the plan alone or together with other shareholders) are likely to enhance the economic value of the plan's investment in that corporation after taking into account the costs involved.

Strong corporate governance and financial discipline has been shown to add value by increasing returns[1] and/or mitigating risk.[2] The strong governance and financial discipline of a firm help ensure the company is being run for the long-term benefit of shareholders and not the short-term benefit of managers. Shareholder engagement in relation to material ESG themes can lead to better investor outcomes and is not only related to promoting collateral social benefits.

Conclusion

In conclusion, we believe that the recent DOL bulletin should not discourage fiduciaries from pursuing ESG-related investment strategies. Any investment strategy, ESG themed or not, should be properly vetted against the objectives of a plan's investment policy statement. Properly designed investment strategies promoting ESG themes can be appropriate in meeting the fiduciary requirements of a plan sponsor.

Important Information

[1] "Unlocking the Performance Potential in ESG Investing," by Li, Sherrerd, and Treussard, Research Affiliates Publications, March 2018.
[2] "ESG Factors and Risk-Adjusted Performance: A New Quantitative Model," by Kumar, Smith, Badis, Wang, Ambrosy, and Taveres, *Journal of Sustainable Finance and Investment*, 2016.