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The Forum for Sustainable and Responsible Investment

GAO REPORT VALIDATES ROLE OF ESG IN RETIREMENT PLANS

A new report by the Government Accountability Office (GAO) Retirement Plan Investing: Clearer Information on Consideration of Environmental Social and Governance Factors Would Be Helpful validates the role of environmental, social and governance (ESG) considerations in investing, provides insight on why retirement plans have largely not yet adopted sustainable investment strategies and makes recommendations for action by the US Department of Labor (DOL).

ESG investing - investments made using environmental, social and governance criteria - has grown rapidly in the US and with $8.72 trillion in assets under management according to the US SIF Foundation's 2016 Report on US Sustainable, Responsible and Impact Investing Trends. The growth in the US is mirrored globally. The Global Sustainable Investment Alliance's (GSIA) 2016 report Global Sustainable Investment Review found that there are now $22.89 trillion of assets being professionally managed under responsible investment strategies, an increase of 25 percent since 2014.

Despite the growth, GAO's report finds that few public and private retirement plans in the United States provide retirement plan options utilizing sustainable investment strategies. European retirement systems, by contrast, are more likely to incorporate ESG factors systematically into their funds. GAO surveyed three European plans – two for public sector employees and one for private sector employees. All three reported using screening and integration strategies to systematically incorporate ESG into their portfolios.

Findings Strongly Support the Incorporation of ESG Criteria

The report states that ESG factors are a way for investors to assess potential risks and opportunities that otherwise may not be taken into account.

> **"The asset managers interviewed for the report said the benefits to integrating ESG criteria were enhanced risk management, improved long-term performance and increased plan participation."**

GAO's survey of academic research found a neutral or positive relationship between investments that took ESG criteria into account and financial returns. The report cites a 2015 meta-analysis of 2,000 empirical studies that concluded that 90 percent of the studies found a neutral, positive or mixed (non-negative) relationship between ESG integration and financial performance.[1] Further, the report cites a 2017 DOL-commissioned study that suggests integrating ESG criteria, "generally produced investment performances comparable to or better than non-ESG investments."[2]

Factors Contributing to Low Uptake in Retirement Plans

GAO interviewed retirement plan asset managers to understand what may be inhibiting retirement plans from integrating ESG strategies. A few key factors emerged in the study.

- Inconsistent and incomparable data was cited by many of the asset managers and plan representatives. ESG data is not always disclosed by companies and ratings agencies, making it challenging to get a clear picture of how ESG factors are impacting their portfolios. When there is data, it can be reported in multiple fashions making comparisons difficult. This finding is consistent with what the US SIF Foundation concluded in its paper on Unlocking ESG Integration.[3]

- The myth of underperformance still exists despite the findings in the academic review. Some of the asset managers in the report stated that their clients had concerns or did not understand how ESG factors would help them reach their goals. A few managers themselves believe there are adverse effects when including ESG.

- Managers mentioned that changes in the Department of Labor (DOL) guidance on ERISA governed retirement plans are causing confusion. DOL 2008 guidance appeared to discourage plans from considering environmental and social factors. In 2015, DOL revised this guidance and noted that ERISA presents no legal barrier to fiduciaries integrating environmental, social and governance (ESG) factors into the investment process. The 2016 bulletin added that proxy voting is consistent with fiduciary duties under ERISA. In 2018, DOL issued a Field Assistance Bulletin to clarify the 2015 and 2016 guidance.

- Managers cited that the costs necessary to implement an ESG strategy, develop in-house expertise or hire consultants might lead to increased plan costs. Increased complexity was mentioned as a potential obstacle as incorporating ESG factors could mean adding additional fund options at a time when the industry is making efforts to simplify plan offerings.

GAO Recommendations

The report makes two recommendations to the US Department of Labor. First, it recommends that DOL clarify whether an ERISA plan may incorporate ESG factors into the management of a qualified default investment alternative (QDIA). QDIAs are used by defined contribution plans to automatically place participants in a default investment option if the participant doesn't select another option. DOL addressed this recommendation in its Field Assistance Bulletin 2018-01 by clarifying that a QDIA may still include ESG criteria but certain funds require more scrutiny to be included.

The second recommendation is for DOL to provide additional information on ESG investing so that fiduciaries may better evaluate available options.

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[1] Gunnar Friede, Timo Busch and Alexander Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies," Journal of Sustainable Finance & Investment, vol. 5 no. 4 (2015).
[2] US SIF has compiled academic and industry reports related to performance at www.ussif.org/performance
[3] US SIF Foundation Unlocking ESG Integration. (2015) https://www.ussif.org/files/Publications/UnlockingESGIntegration.pdf