Market Commentary | Second Quarter 2016

STOCKS, BONDS and ESG

We wrote in Q1 2015 that impact investing had gone mainstream. The Employee Retirement Income Security Act of 1974 ("ERISA"), which regulates single-employer and multi-employer private pension plans, now officially agrees. Recent regulatory guidance clarifies that ERISA fiduciaries may now consider ESG, impact and other factors in their investment decisions.

In the first half of the last century, common law concepts of fiduciary duty and prudence generally required a narrow, risk-averse approach when investing on behalf of others (e.g., pensions and trusts). Typically, such portfolios consisted solely of high quality corporate and government bonds, often arranged to match the projected cash needs of the beneficiaries. In 1952, Harry Markowitz introduced his modern portfolio theory: adding non-correlated investments to a portfolio could increase the expected rate of return while maintaining the same level of risk. As this theory gained acceptance, fiduciary standards evolved with it such that well-managed portfolios generally should contain a diversified mix of stocks and bonds and a few other "alternative investments." The alternative investments may have seemed exotic in their day—things like venture capital, buyouts and merger arbitrage in the 1980s and 1990s and hedge funds, emerging markets and managed futures in the 2000s—but are so common today that their "alternative" label has all but disappeared.

Beginning in the late 1980s, additional investment considerations began to arise. The takeover and dismantling of RJR Nabisco (and the golden parachutes for executives and pink slips for line workers) circa 1988-90 and the collapse of Enron ten years later, were watershed moments that focused investors on the importance of governance and the role investors (particularly pension plans) could play in affecting market behavior. Governance, accountability and transparency greatly improved in the ensuing years. In the early 2000s, CalPERS, CalSTRS and others began to raise concerns about the environment and found ways to address it through the 2004 Green Wave initiative and other means. Early stock-screening initiatives and shareholder activism cajoled well-established industrial conglomerates to reduce pollution, adopt sustainable business methods and to stop resting on their laurels and start innovating again. Later efforts, mostly through venture capital investments, further accelerated technological innovation, creating new jobs and industries centered around electric vehicles, LED lighting and solar photovoltaics, among others.

Other parts of the world began embracing environmental, social and governance ("ESG") factors about the same time. The U.K., for example, passed the U.K. Pensions Act in 2000 requiring disclosures of sustainability factors used in portfolio construction. Germany, France, Sweden, Australia and South Africa all incorporated ESG or sustainability concepts into their pension/retirement systems over the last 15-20 years. The motivation seems obvious but was less so 15 years ago: it is prudent when choosing between an investment in two companies whether one makes more efficient use of its inputs (resources such as raw materials and energy used in production or shipping) or takes proactive steps to reduce pollution, recycle scrap materials, and uphold modern moral standards about child labor and work conditions. Often such factors can be measured at the bottom line of companies, in terms of reduced input costs, better employee productivity and avoiding labor, anti-corruption and environmental lawsuits. It also seems intuitive today that companies that "do good" enjoy other economic benefits such as higher worker retention, support from local communities and government pay off in the long run.

In light of this, the DOL updated the ERISA fiduciary standard to explicitly permit the use of ESG factors when making investment decisions for plan assets. Previous DOL guidance (in 1994 and 2008) allowed ERISA fiduciary to take such factors into account solely as a tie-breaker between two otherwise economically and financially equal investment choices (as if such things exist in the wild), provided such decisions were (1) rare and (2) well-documented to show compliance with ERISA's rigorous fiduciary standards. Understandably, ERISA fiduciaries felt deterred from utilizing ESG factors in recent years.

With this latest guidance, ERISA fiduciaries have the latitude to delve deeper than risk and return. They can consider whether an investment might create jobs (including jobs that will provide new cash inflows to the pension plan, thus strengthening it) or protect the environment or promote sustainability or some other social good. While ERISA does not permit fiduciaries to sacrifice the economic interests of plan participants in order to promote collateral goals, ESG factors can be proper components of the fiduciary's primary analysis of the economic merits of competing investment choices. This is an important milestone, as $2.7 trillion of U.S. pension plan money is now free to do well by doing good.

Source: Deloitte, Asset Allocation of Defined Benefit Pension Plans, November 19, 2015.