# HYAS GROUP
## RESPONSIBLE INVESTING

*Ned Taylor, Senior Consultant*
*Matt Morganroth, Senior Analyst*

JULY 2019

# RESPONSIBLE INVESTING


## SUMMARY

- The DOL's position on responsible investing has wavered between support and mere tolerance.
- Responsible investing does not appear to automatically violate DOL guidance in that performance and risk are not necessarily sacrificed.


## INTRODUCTION

Recent investor sentiment has called for more than just investment performance from portfolios. There has been increased activity in investment opportunities that feature responsible investing practices. Responsible investing is a broad term incorporating several types of strategies, most commonly including environmental, social, and governance ("ESG") investing, socially responsible investing ("SRI"), and impact investing. ESG investing generally incorporates a broad, factors-based approach linking company aspects such as governance (e.g. company leadership, executive pay, internal controls, etc.), shareholder rights, or environmental practices to investment potential. SRI more narrowly turns to avoiding companies with exposure to controversial products and practices such as alcohol, tobacco, firearms, and gaming. Lastly, impact investing focuses on companies that are expected to provide a benefit to the environment or society (e.g. renewable energy, healthcare, housing projects, etc.). With wavering regulatory guidance and minimal industry alignment, advisors and retirement plan sponsors have been left to their own devices to evaluate the broad array of investment opportunities in this space. This analysis may serve to inform plan sponsors' views on investments featuring responsible investment practices.

## REGULATORY GUIDANCE

The U.S. Department of Labor ("DOL") has an irresolute history regarding its stance on the suitability of responsible investments (referred to as economically targeted investments or "ETIs") in defined contribution plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). The DOL provides a definition for ETIs that is similar to the types of responsible investing defined above: ETIs are investments identified by their economic or social benefit apart from their investment return[1]. With Interpretive Bulletin 1994-01 the DOL stated that plan fiduciaries are not prevented from investing plan assets in an ETI if its expected rate and return

[1] Federal Register Vol. 80, No. 206, *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments*. October 2015.

is comparable to those of similar alternative investment options. In 2008, nearly fifteen years later, the DOL took a less open stance in Interpretive Bulletin 2008-01. While the previous principle permitting the use of ETIs in defined contribution plans was not overturned, the DOL clarified that the consideration of ETIs and their collateral benefits should be rare and, when considered, documented rigorously under the fiduciary standards of ERISA.

In more recent years, additional bulletins have appeared taking two steps forward in acceptance of ETIs and one step backward. Interpretive Bulletin 2015-01 replaced the 2008 Interpretive Bulletin and set out to again clarify the DOL's stance on ETIs. Not only can plan fiduciaries include responsible investing factors as tiebreakers for investments with similar risk and return characteristics, but they may also evaluate these factors for their direct relationship to the economic value of a plan's investments. The bulletin, however, acknowledges that the terms and definitions around responsible investing are continuously evolving and have no uniform meaning. Similarly, Interpretive Bulletin 2016-01 added to the DOL's stance that ETIs or ESG factors could be incorporated into Investment Policy Statements. This Bulletin reiterated that ESG-related tools, metrics, and analyses can be used to evaluate an investment's risk or return and that ESG factors can be used as a tiebreaker to choose among otherwise equivalent investments. The DOL's latest guidance can be found in Field Assistance Bulletin 2018-01. In this bulletin, the DOL says fiduciaries must not too readily treat ESG factors as economically relevant and instead a fiduciary's evaluation of the economics of an investment should be focused on financial factors with a material impact on the risk and return of an investment. Fiduciaries must always put first the economic interests of the plan in providing retirement benefits.

## INDUSTRY ADOPTION

The DOL's back and forth positions aside, the investment industry has generally moved towards the acceptance of responsible investing over the past decade. CFA Institute recognizes that incorporating responsible investing factors, when relevant, is an important component of a complete and thorough financial analysis and that ESG-related disclosures provided by corporate issuers still require further standardization and refinement to improve their quality, consistency, and comparability of key factors. Despite the increasing number of investment products and broad indices catering towards responsible investing, there has been no centralized definition of exactly what responsible investing should entail or how related factors should be reported. National and global groups have been growing in both number and size over the years in an attempt to standardize aspects of responsible investing. These groups have focused on company reporting standards (e.g. the International Integrated Reporting Council and the Sustainability Accounting Standards Board) as well as investment practices (e.g. the Principles for Responsible Investment Group and the US SIF: The Forum for Sustainable and Responsible Investment). Some industry leaders in investment management such as S&P Dow Jones, FTSE/Russell, and MSCI have created market-capitalization weighted indices for both broad-based responsible investing as well as for more focused ESG factors.

Absent more precise regulatory guidance, sustained growth in responsible investing may be the key to encouraging common practices and treatment by the industry. According to Morningstar's Sustainable Funds U.S. Landscape Report, record cash flows into responsible investing products (open-end funds and exchange-traded portfolios) were recorded in 2016, 2017, and 2018. Nearly $5.5 billion in net flows were attributable to responsible investing in 2018 alone, bringing assets under management to $89 billion[2]. This third consecutive record-setting year of cash flows comes alongside the lowest calendar-year flows for the overall U.S. fund universe since 2008. Despite total assets in responsible investments being only a fraction of overall fund assets under management (approximately 0.5%), the growth in 2018 represented 3.5% of overall fund flows.[3] While these statistics capture most managers who follow responsible investing practices by prospectus objective, it does exclude funds that only use values-based exclusionary screening (such as the exclusion of tobacco, alcohol, and gambling or faith-based criteria restrictions only).

## INVESTOR IMPACT

The question remains: has the retirement plan industry been right to move towards accepting responsible investing practices absent further guidance? The broad range and variety of responsible investing strategies can make this a difficult question to answer. In an attempt to answer this question, we focus on three leading responsible equity indices versus the traditional S&P 500 index. Each of these indices are similar to the S&P 500 in that they are market-capitalization weighted and emphasize U.S. large capitalization companies in their composition. They differ in the fact that they employ various responsible investing screens. This aligns with the DOL's guidance that responsible investments should provide a similar experience to that of the broad market of their asset class; these indices should neither require sacrificing performance nor taking on additional risk relative to the broad market to achieve their respective responsible investing strategies.

### TRAILING PERFORMANCE (ANNUALIZED AS OF 12/31/2018)

| | 1YR | 3YR | 5YR | 10YR |
|---|---|---|---|---|
| DOW JONES US SUSTAINABILITY | -2.95 | 10.78 | 8.80 | 12.40 |
| FTSE4GOOD US | -3.22 | 10.45 | 10.16 | 14.14 |
| MSCI KLD 400 SOCIAL | -3.50 | 9.19 | 8.17 | 13.09 |
| S&P 500 | -4.38 | 9.26 | 8.49 | 13.12 |

**PERFORMANCE +/- INDEX**

| | 1YR | 3YR | 5YR | 10YR |
|---|---|---|---|---|
| DOW JONES US SUSTAINABILITY | 1.43 | 1.52 | 0.30 | -0.72 |
| FTSE4GOOD US | 1.16 | 1.19 | 1.67 | 1.02 |
| MSCI KLD 400 SOCIAL | 0.88 | -0.07 | -0.32 | -0.03 |

[2] Excludes funds that have recently added ESG criteria where none applied before and those that have been entirely repurposed as responsible funds because many of these funds already maintained large asset bases.

[3] Jon Hale, Ph.D., CFA, *Sustainable Funds U.S. Landscape Report.* Morningstar Research, February 2019.

Returns for the responsible investing indices are comparable to that of the broad market, both outperforming and underperforming over various time periods for the past ten-year period. Returns in the table are highlighted such that green is the top performer for the period and red is the bottom performing. Over the trailing one-year period the responsible indices had a relatively tight range of performance and were within 55 basis points of each other, with the broad market lagging 143 basis points behind the top performer and 88 basis points behind the worst performer. Over longer periods the variance between the responsible indices increased slightly with the broad market performing within their range generally. The ten-year variance between the top and bottom responsible indices spanned 174 basis points. The broad market was 102 basis points behind the top performer and 72 basis points ahead of the bottom performer.

Performance alone is not enough according to the DOL guidance. Risk as measured by standard deviation and other risk-adjusted measures for these indices should also be comparable to the broad market. For the trailing ten-year period, the standard deviation for each of the responsible indices and the broad market are tightly grouped. Similarly, the Sharpe Ratio – a measure of risk-adjusted performance – of each of these indices is comparable to the broad market. Both risk metrics suggest that incorporating responsible investing practices has not necessitated taking on additional risk relative to the broad market. While performance and risk statistics for these indices is comparable to the broad market, they do show tracking error relative to the broader market over both short- and long-term periods. Tracking error, a measurement of the volatility of the difference between an investment's returns versus those of its benchmark, is not necessarily a bad thing as these indices are not meant to tightly track the S&P 500's performance. But rather tracking error is important as it represents the risk of substantial performance deviation from the broad market. While performance and risk may be comparable to the broad market, the inclusion of responsible investing practices does change expected investment results.

## TEN-YEAR RISK STATISTICS (AS OF 12/31/2018)

| | STANDARD DEVIATION | SHARPE RATIO | TRACKING ERROR |
|---|---|---|---|
| DOW JONES US SUSTAINABILITY | 13.46 | 0.91 | 2.09 |
| FTSE4GOOD US | 14.14 | 0.98 | 2.52 |
| MSCI KLD 400 SOCIAL | 13.65 | 0.94 | 1.83 |
| S&P 500 | 13.60 | 0.95 | - |

## CONCLUSION

Responsible investing practices do not appear to automatically violate DOL guidance in that performance and risk have not been sacrificed in order to achieve social goals. This analysis however only covers the framework of responsible investing in the broadest sense by observing several non-investable indices relative to the broad market and does not evaluate individual strategies. Additional factors that should be considered include fund composition and asset allocation.  For fund composition we need to consider if the universe of potential investments is too limited due to responsible investing principles, or if the principles are too broad leading to the social factors losing their merit. The asset allocation considerations include whether or not investors overweight equity or fixed income as a result of including any responsible investments in their portfolios. Individual investments should be reviewed for their own merit compared to a relevant benchmark and a proper asset allocation should be followed with respect to an individual's risk tolerances when considering including responsible investments in their portfolios. While the DOL's position on responsible investing has wavered between support and mere tolerance over the past twenty-five years, two points have held steady. First, fiduciaries cannot accept lower investment returns or higher risks to promote a cause through responsible investing practices. Second, ESG factors are an acceptable consideration as a tie-breaker in the case that all else is equal between two investment options. This provides fiduciaries with some guidance, however broad, to operate within when evaluating responsible investing.