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Fiduciary Hot Topics

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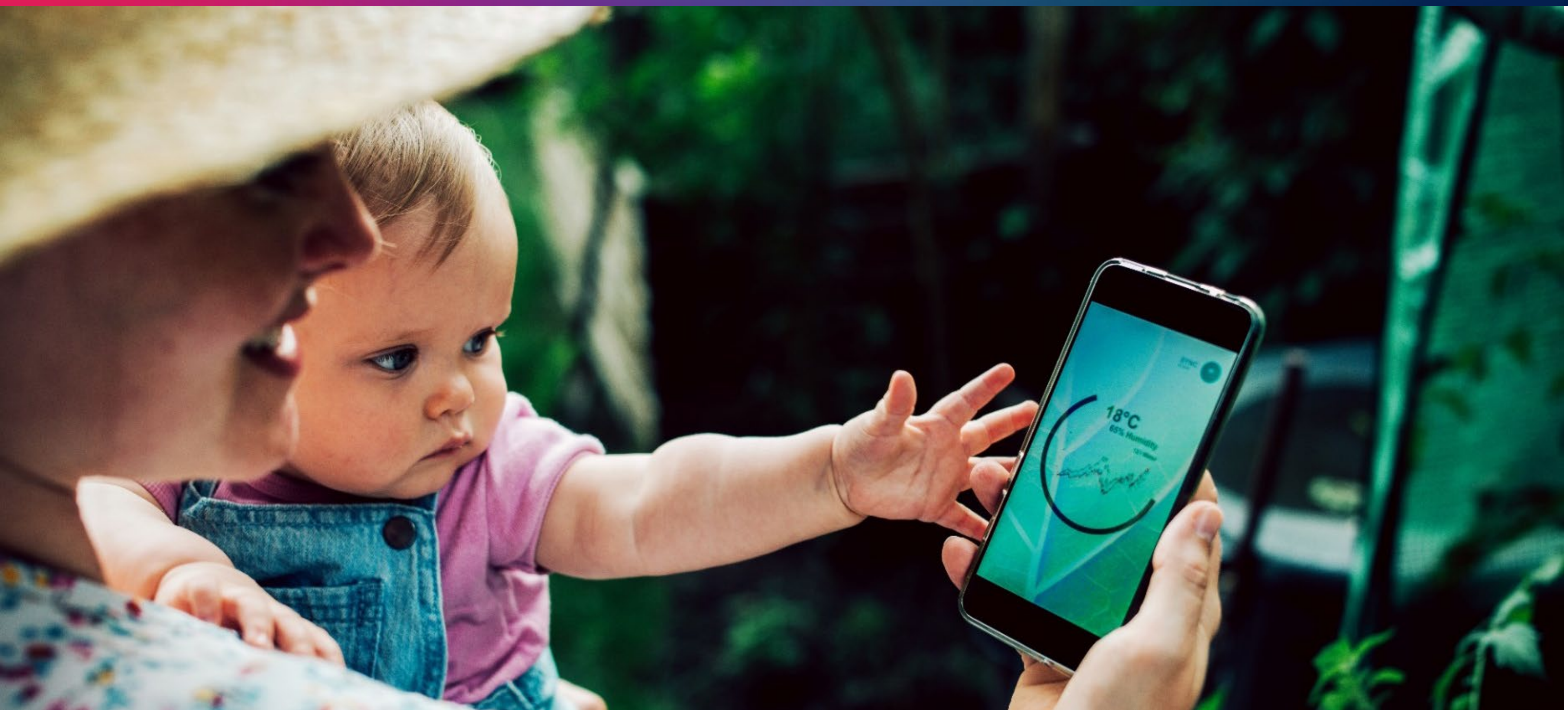

The Challenges for ESG Investing

- ESG investing, sometimes known as socially responsible investing, aims to generate returns by picking stocks based on environmental and social concerns and issues of corporate governance, in addition to looking at the financial metrics of companies. ESG investing has grown rapidly as investors are becoming more interested with these issues. ESG fund growth is expected to exceed $40 trillion this year. Even traditional asset managers, who do not follow an ESG strategy, are feeling pressure to adopt ESG policies that require consideration of factors other than traditional financial criteria in evaluating companies.

- ESG investing has some unique investment aspects. First, “ESG” has no precise legal, or industry, definition. The Securities and Exchange Commission has expressed concern that investment firms are using ESG to market their actively managed products that address issues such as climate change and diversity only superficially. And there are certainly some ESG funds that do not appear to lean very far into the concept. Its’s not unusual for the underlying holdings of an ESG fund to be similar to other funds that invest in the stocks of large U.S. companies.

- An example of the Securities and Exchange Commission’s growing concern is the investigation it has launched into four Goldman Sachs mutual funds that are being marketed as ESG funds. One of these funds, formerly called the “Blue Chip Fund,” was renamed “The US Equity ESG Fund” in 2020. After this name change, the top three holdings remained the same. The fund’s other top holdings include Bristol-Myers Squibb, Eli Lilly and JP Morgan Chase. In the Fund’s prospectus, Goldman reserves the right to invest in some companies without an ESG analysis.

- A potential challenge is that the ESG factors given priority depends, in large part, on the public mood. For example, ESG funds frequently focus on carbon emissions, and many exclude defense stocks. Prior to this year, these criteria had wide appeal. However, the Russian invasion of Ukraine illustrates how quickly the public mood can change. The public's focus has shifted to the hardship that high energy prices are creating for many. The US government, along with its western allies, is focused on increasing the global oil supply. Concern about climate change, at least for the time being has, to some extent, been temporarily deemphasized. And with the new geopolitical reality created by Russia's aggression, there is an increased appreciation of the need for national defense, including a nuclear deterrence.

- Another challenge is that ESG ratings can be subjective. Although the CFA Institute is working on a common standard, none currently exists for measuring ESG elements in the investment industry. Most investment managers do not develop their own ESG ratings. Rather, they rely on the ratings of companies with expertise in ESG metrics. And there is little consistency in scoring/rating from one scoring system to the next.

- A fundamental principle of ESG investing is that companies with sustainable business practices that rank high on ESG metrics will outperform over the long term. A study conducted last year by the Wall Street Journal sorted 492 companies into three groups- ESG leaders, average ESG performers, and ESG laggards based on data provided by three rating companies. The study looked at stock price performance in 2020 and the first part of 2021. The study showed that depending upon the scoring system, this fundamental principle is still unproven.

- Add in the fact that recently the Department of Labor issued proposed regulations purporting to insert the consideration of ESG into prudent fiduciary investment processes and the potential complexities of the arena – particularly for ERISA fiduciaries – becomes of considerable importance. At this juncture the prudent fiduciary should either wait to see the outcome of the regulations upon finalization, or if they desire to add ESG at present, to do so with a primary eye towards pecuniary objectives with the ESG being a secondary consideration.

Industry Consolidation Has Been Significant

- Unlike investment management, defined contribution record keeping is a labor-intensive business with relatively thin margins. In order to compete effectively, some firms have increased their scale by acquiring other players. These include Empower, Principal and John Hancock. This consolidation has resulted in a number of major companies exiting the business altogether including MassMutual, Prudential and Wells Fargo. It is probable that the more players will exit in the future.

- The upside to this consolidation is that it enables the large record keepers to make the necessary investments in their business for matters such as cloud computing and cybersecurity. The concern is that the consolidation gives these record keepers greater pricing power allowing them to increase the record keeping fees that plan sponsors must pay.

- Over the past decade there have been 66 consolidations and 40 companies decided either to exit or out-service their record keeping. The more significant transactions are listed below.

PRIOR VENDOR	NEW VENDOR	TRANSACTION
	2021	
Prudential	Empower	Acquired
Fifth Third Bank	Empower	Acquired
Ascensus	Newport	Merger
	2020	
Nationwide (advisor sold business)	SS&C	Outsourced
MassMutual	Empower	Acquired
Vanguard DC recordkeeping	Infosys	Outsourced
	2019	
Wells Fargo IRT business	Principal	Acquired
	2017	
AON's benefits admin. unit	Blackstone Group	Acquired
	2016	
Guardian	Ameritas	Acquired
	2015	
Mercer	Transamerica	Acquired
	2014	
New York Life	John Hancock	Acquired
Newport Group/Verisight	Newport Group	Merger
City National Bank	OneAmerica	Acquired
JP Morgan, Putnam	Great-West	Acquired
DailyAccess	Verisight	Acquired
	2012	
Expert Plan	Ascensus	Acquired
Hartford	MassMutual	Acquired
The Pension Specialists	ExpertPlan	Acquired

- The reason this should remain on your radar is to determine whether you should expect potential enhancements (as your recordkeeper acquires other organizations they may be acquiring unique technology, ideas, or personnel) or disruption (if your recordkeeper is acquired it may be accompanied by confusion by participants, changes in your daily plan-related operations, or a full-blown conversion to another system).

The Secretary of Labor tells Congress he is open to Regulating Cryptocurrencies

- Recently, the Department of Labor has been aggressive in issuing guidance for plan fiduciaries regarding their investment decisions that goes beyond the general fiduciary standards in ERISA. Last March, the Department issued a Compliance Assistance Release cautioning fiduciaries of defined contribution plans to exercise “extreme caution” in considering cryptocurrencies. This follows on the recently issued proposed regulations regarding ESG investing and a cautionary letter stating the Department does not view private equity as an appropriate investment for most defined contribution plans.

- The Secretary of Labor, Marty Walsh, has stated he is open to the Department promulgating rules regulating cryptocurrencies in retirement plans. He made this statement in testimony he gave before the full House Committee on Education and Labor this past June. The Secretary was seeking approval of the Biden administration's 2023 $14.6 billion budget request for the Department. He offered no details beyond stating the Department is contemplating a rulemaking process for cryptocurrencies.

- This rule may never come to fruition as investors’ interest in cryptocurrencies has waned with the market sell off. Cryptocurrencies have followed the downward trajectory of stock prices. This year, virtually all cryptocurrencies have lost well over half their value with some approaching zero. Year to date, the total value of all cryptocurrencies is down from just over $3 trillion to under $1 trillion.

The US Court of Appeals Squarely Rejects the Argument that Plan Fiduciaries Must Choose Less Expensive Index Funds Over Actively Managed Products. *Smith v. CommonSpirit Health. June 21, 2022*

- In this case, the investment lineup included the actively managed version of the Fidelity Freedom Funds. The plaintiffs argued that the fiduciaries violated their various duties under ERISA by failing to utilize the less expensive index version of these funds. The District Court granted CommonSpirit’s motion to dismiss. A motion to dismiss is granted only if the court believes there will be no basis to grant relief even if the plaintiffs prove all the facts alleged in the complaint. The District Court’s decision was upheld by the Court of Appeals.

- This case is yet another example of plaintiffs arguing that a better outcome could have been achieved if the plan fiduciaries had followed their preferences rather than arguing that the fiduciaries utilized a defective process in reaching their decisions. The District Court made it clear that merely pointing to funds with better performance is not sufficient to prove a violation under ERISA.

- The Court of Appeals’ in rejecting the plaintiffs’ arguments, stated that “the Employee Retirement Income Security Act . . . does not give the federal courts a broad license to second guess the investment decisions of retirement plans. It instead supplies a cause of action only when retirement plan administrators breach a fiduciary duty by, say, offering imprudent investment options.”

- The Court was comfortable with the fact that actively managed products are more expensive. The Court stated “Investors today have the option of using index funds, which create a fixed portfolio structured to match the overall market or a preselected part of it, which require little to no judgment, and which have grown in popularity as an alternative to active management, . . . Little surprise, actively managed funds, which require considerable judgment and expertise, charge more than passively managed funds, which require little judgment and expertise.” The Court added that it could be imprudent for a plan not to offer active choices.

For more information on retirement issues, call 1.844.4Lawley.

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