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New Guidance on SRIs

What plan committees need to know

The Department of Labor (DOL) has issued guidance that eases the fiduciary burden for selecting socially responsible investments. By socially responsible investments, we mean funds that apply environmental, social and governance (ESG) factors in managing the fund. These funds can also be referred to as economically targeted investments (ETIs).

Prior DOL Guidance

Committees may have wanted to add ETIs to their plan lineups to appeal to Millennials. Or, including such investments may be consistent with the culture of a socially conscious or environmentally sensitive company. Until now, adding ETIs to a fund lineup was potentially problematic. Prior DOL guidance seemed to impose what the DOL itself called a "higher but unclear standard of compliance for fiduciaries." The new guidance, however, makes it clear that ESG factors can be valid criteria for selecting investments. It also makes it clear that the fiduciary standards for evaluating ETIs are no different than for non-ETI investments.

The DOL says that committees can consider the social issues of concern to their workers, but cannot ignore financial performance. Plan committees cannot "sacrifice the economic interest of plan participants in receiving their promised benefits in order to promote collateral goals." Selecting an investment that provides a lower expected return or higher risk for the same expected return would not be prudent. This is true whether the investment addresses ESG issues or not.

In contrast to its earlier guidance, the DOL notes that ESG issues may directly affect the economic value or the expected return of an investment. When that is the case, these issues can be considered as "primary" evaluation factors when selecting among various alternatives. Per the DOL, ESG factors can even be incorporated into investment policy statements (IPSs). On the other hand, there may be many prudent choices available within an asset class. When two or more investments are otherwise equivalent, the ESG factors may be "secondary factors." That is, they may be used as tiebreakers to decide which one to pick.

What do committees need to know when selecting investments that reflect ESG factors?

First, it is acceptable to select ETIs, as long as they are otherwise prudent. Committees must act prudently in selecting a plan's investments. They have to compare options in the same asset class against the market and consider each alternative using common measures. These include matters such as how a fund fits the plan's investment policy, past performance, volatility, cost, manager quality, etc.

As a part of the evaluation, a committee needs to understand whether ESG features will affect the expected return. This could be positive, because of improved performance due to the inclusion or exclusion of certain industries in the fund's investments. Or it may be negative, because of business constraints that competing funds will not face. Either way, the ESG elements become primary factors to be evaluated along with the quantitative and qualitative performance factors. If ESG features are expected to have little or no impact on performance, they fall into the secondary-factor, "tiebreaker" category. Where comparable investments are indistinguishable except for ESG factors, those factors may weigh in favor of the ETI.

In all events, however, an ETI would not be prudent if investment performance is expected to be worse than for other alternatives with similar risk.

A New World

Consideration of ESG factors likely presents a new world to plan committees, one in which they do not feel especially comfortable. If so, a committee should work closely with its adviser to identify ETIs that satisfy the risk and return criteria. Committees may also offer brokerage or mutual fund windows to allow participants to select from among numerous investments, including ETIs, keeping in mind that selecting a brokerage window raises fiduciary considerations that are beyond the scope of this article.

The final step in the process, as in all other cases, is to document the assessment that is made and monitor the decision frequently.

Plans do not have to offer ETIs. Before now, DOL guidance seemed to discourage doing so. The new guidance means committees can now feel more comfortable in following their consciences.

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