It’s Good for the Planet and It’s Good for Your Portfolio

Encouraging Millennial Participation in 401(k) Plans Through Lowering Barriers to ESG Investing

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All opinions and analysis are my own, and do not represent legal advice or the opinions of my employer.

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The Main Idea

Climate change is widely recognized as an imminent, global threat.

Investors (especially "millennial" & "Gen-Z") aligning investments to sustainable values.

Skyrocketing popularity in "ESG" (environmental, social, & governance) investing

But access to ESG is limited in the US because of strict regulation of retirement plans

- Less than 10% of 401(k)s have ESG investment options

This is about to change– new Biden DOL rule eases these regulations

Change the regulation → change 401(k) offerings → increase retirement savings → increase investment in sustainable businesses

Rare win-win

What is ESG Investing?

- "values based", "socially responsible investing"
- Investors examine ESG factors as part of overall investment analysis
- "Who Cares Wins": direct connection between performance on ESG metrics and overall corporate risk management and brand value
- Different methods of ESG investing:
  - ESG exclusionary/ negative screening (active or passive)
  - **<u>ESG inclusionary (active)</u>**
  - **<u>Impact investing (active)</u>**
- Meta-analysis of ESG investing studies shows stable and positive relationship between ESG factors and corporate financial performance
- "the norm" in financial & insurance industries

<u>Morningstar:</u> "a <u>risk-management</u> process, as companies that embrace sustainable practices are <u>managing liabilities better</u> than others, perhaps recognizing new opportunities, and may be <u>better positioned to grow</u> in the future. Environmental, social, and governance investing has evolved from funds that simply screened out undesirable companies like polluters or sellers of tobacco to strategies that apply a matrix of sophisticated screens to <u>assess the best and worst players</u> in every industry and actively seek to have a positive impact in many ways"

How Can ESG Investing Address the Retirement Crisis?

High demand for ESG products but they are largely absent in employer-sponsored retirement plans

Americans (particularly millennials) under- participate and under-contribute

Retirement plan studies show that vast majority of participants would contribute more if offered an ESG option

1/4 of surveyed millennials said either do not participate or under participate in 401(k) because they are participating in other investment vehicles

Likely would impact savings behavior *at the margin*, but this matters for a millennial

Where are those dollars going now?
Millennials are most active age group on other *taxable* investment platforms (e.g., Robinhood- average age 31- top investments are in clean energy)

28-year-old saves an additional $100/month, pre-tax → compound to additional $399,447.78 (retire @ 65 & assume 10% annual return)

So, Why Do So Few US Employer-Sponsored Retirement Plans Offer ESG Options?

- Employee Retirement Income Security Act of 1974, as amended (ERISA)
- Complex web of regulations imposing strict fiduciary duties on plan sponsors – **LOYAL** to the best financial interests of the plan & **PRUDENT** investment decisionmaking (responsible investment process)
- Dep't of Labor (DOL)– key administrative agency that interprets and enforces ERISA
- Regulatory ping-ping on sustainable investing since the '90s: Democratic DOL interpret fiduciary duties of loyalty and prudence to encourage ESG type investing– Republican DOL interpretations are more skeptical
- Uncertainty → increased liability risk to investing ERISA-regulated assets in ESG
- Most recently: Financial Factors in Selecting Plan Investments (2020 Trump era regulation)– cast suspicion on prudence of ESG investing and increased bureaucratic red tape for plans looking to consider ESG factors

How is a New Regulation About to Change That?

Oct 2021: Biden DOL released a proposed rule: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (the "Proposed Rule")

Reverses presumption on fiduciaries' consideration of ESG factors from suspiciously imprudent to financially responsible, but keeps the regulation focused on **financial materiality**

Duty of loyalty: consideration of ESG factors can often be in the best financial interest of the plan– ESG factors can be material to risk/return analysis

Duty of prudence: look at how the financial industry is behaving– prudent investment decisionmaking may often include *or require* consideration of certain ESG factors (current draft of rule does not presume any one ESG factor to be material-- it depends on the context)

Bottom Line: fiduciaries still must focus on the best financial interests of the plan– but DOL suggests ESG can (and in some cases should) play a part in achieving that goal

What Would This New Regulation Mean for US Employees and the Retirement Plan Industry?

Proposed rule is not binding–

comments accepted until mid-December, revised version issued and binding within the next few months.

Already seeing increased interest from plan sponsors in adding ESG investments to 401(k) lineups

(no surprise, since employees have been asking for it for a long time)

Market for ESG-friendly funds would expand *drastically* →

ripple effect on financial industry and larger corporate world

More ESG-friendly options →

more participation and contribution to retirement plans →

more retirement savings *and* more $ for sustainable companies.

Caveat: what about the ping-pong?

My Personal Opinion: unlikely:

(1) hard to walk it back once US regulatory environment aligns closer with Europe & Canada;

(2) hopeful that feedback during the comment process will make the final bidning rule a bit softer on ESG-specific language and more principles-based– harder to flip it back

Q&A