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TRANSCRIPT

Dude, where's my sustainability?

Featuring:

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Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is February 10th, 2022. Today we are talking about retirement, that mythical time out there in the future somewhere, where we're burdened neither by deadlines or team meetings. Like me, maybe you daydream about retirement from time to time, but how often do you think about how it's funded? Well, the US to Department of Labor, they spend a lot of time thinking about that part. In last fall, they released proposed changes to the rules, the regulations about how fiduciaries of retirement plans can consider environmental, social and governance factors for the investments on their plan menus. Specifically, they're allowing it, which is a 180 degree turn from the previous deal or guidance. It's a big deal. And on today's show, we'll hear from three experts. Our first is.

Stacey Tovrov (01:17):

Stacey Tovrov and I head investment strategy for the retirement solutions team at BlackRock. My responsibility and my team's responsibility is to work really closely with our lifecycle research team that's responsible for managing our $400 billion target date franchise here at BlackRock called LifePath.

Adam Bass (01:40):

Life cycle or target date funds, they're an important part of many retirement plans in the US. This is mostly because plan participants don't have to think too much about them. Generally, all you do is select the targeted fund whose name has a year close to the year you expect to retire. Then the mix of investments in that fund, well, it changes automatically. It moves toward traditionally less risky assets as that year gets closer, but back to Stacy.

Stacey Tovrov (02:13):

So I think this is an incredibly important topic within the defined contribution space, because we do know that kind of the regulatory environment is an important driver for how plan sponsors can

evaluate different investment options for their lineups. We're generally incredibly excited to see the direction that the department of labor is moving in specifically recognizing that sustainable investments can be an important part of understanding the financial risk that participants and beneficiaries may face. And that there is not a specific connection of sacrificing investment return when we're thinking about investing sustainably. So overall, we feel that the DOL made several significant and important changes to prior rules that actually reflected some of the recommendations that we put forward back in 2020. So the first is the removal of the definition of pecuniary or actually the removal of pecuniary altogether.

Adam Bass (03:24):

Let's put a pin in pecuniary, it's going to come up a few more times.

Chris Walker (03:30):

At the end of the prior administration, they had proposed a rule that would've gone into effect in the beginning of 2021, that basically would've made it very difficult to consider ESG.

Adam Bass (03:45):

That's Chris Walker. Chris runs the sustainable retirement initiative at the Intentional Endowments Network or IEN. And that prior administration he's referring to of course, is the Trump Administration, which issued its own guidance back in 2020.

Chris Walker (04:03):

This new proposed rule, what is done is completely turn the table and say basically that ESG is a proper consideration for plan sponsors. And I would suggest perhaps now the onus will be more on why aren't you considering ESG? You still have to do ERISA prudence and loyalty, but a part of that is to consider what are factors that will have a long term implication on the fund. And then the other item that I think is really crucial is that for default funds or QDIAs, you can now consider ESG as part of the consideration which was strictly prohibited under the prior proposed rule.

Adam Bass (04:50):

And why is that so significant? Can you go into that a little bit?

Chris Walker (04:54):

Well, the QDIA is basically the default option, meaning it's the option that if an individual hasn't chosen where they would want to have their 401(k) or 403(b) monies going into it's the option that is where the plan sponsor puts the money in on their behalf. And this could be not only whatever amount that automatically would go in, but it could be also any matching funds, et cetera. And so it's absolutely crucial because it's generally the largest investment vehicle within the plan universe of funds.

Stacey Tovrov (05:36):

The new guidance basically ensures that the same criteria or the same selection process can be applied when evaluating ESG investment options or sustainability integrated investment options to both the QDIA as well as the investment menu. So it in effect creates an even playing field between the QDIA and the rest of the investment menu.

Simone Vergote-Ruiz (06:02):

I think that the implications go well beyond the headlines here.

Adam Bass (06:09):

That's...

Simone Vergote-Ruiz (06:10):

Hello, my name is Simone Ruiz Vergote. I work with MSCI ESG Research, and I'm responsible for ESG policy and stakeholder engagement. And as such, I follow regulatory developments around the world when it comes to ESG and disclosure, just looking at the fact that in the previous context, ESG factors were stated to not be pecuniary, which actually led to the fact that they couldn't be considered. And that definitely had an impact. Yeah. So I think when you looked at how prohibiting this was for pension funds to actually look at ESG as a potential material factor, this was really where it ended. And there is a growing body of evidence and research supporting the suitability of ESG integration and the investment process as a financial or pecuniary factor.

And MSCI has done some study that shows that worldwide ESG focus constitutes of our ACWI index have not just seen higher returns, but also stronger earnings, growth and dividends. And the study looks at May 2013 to November 2020. So quite a long seven years period. And the companies with the top tire ESG ratings had a return of 1.3% over the entire universe. And while the bottom tire ESG ratings constituents significantly lacked in the earnings growth. And I think this just shows that you can see this not just from a limiting your downside risk perspective, but also from benefiting from the upside potential of these investments.

Adam Bass (07:46):

Okay. So the DOL is now saying one, ESG can be considered as a factor in retirement plans. And two, default retirement investments in the plans do not have separate requirements from the other plans in the menu. Okay, got it. Well, didn't I just say a few seconds ago that the Biden Administration's 2021 proposed rule contradicts the Trump Administration's from 2020? Talk about whip lash. Are these rules just arbitrary? I asked Stacy about that. There has been obviously a huge swing from what was put forward in terms of ESG a few years ago and what came out last year. Where do you stand in terms of fear? Let's say that this could just continue to go back and forth as we go between different administrations.

Stacey Tovrov (08:52):

Yeah. I think that's a really great point. And one that we certainly hear from many of our clients. It certainly has seemed that sustainability has taken on a political lens. And so over the last few administrations, it's not just the Trump Administration versus the Biden Administration, but over the last few administrations, going back to Clinton and Bush, we have seen this sort of pendulum swinging back and forth in terms of the types of guidance that we see from the administration or the types of rule making that we see from each administration's department of labor related to retirement plans considering sustainable solutions.

Our goal and our hope is that by providing more data around how investment strategies perform that have an ESG objective, or that are ESG integrated by providing the department more data and support of that investment argument and that investment rationale, we think is really important in helping stem that back and forth or kind of flip flopping that we've seen administration to administration. Really what we know to be true from the plan sponsored community is stability is important, right? We want the stability and consistency of guidance from the department to ensure that plans can make these really important investment selection and not be worried that they would have to do a lot of work that can very quickly be overturned or erased if there's a new set of guidelines and guidance coming in from a new administration.

Adam Bass (10:47):

And that's important because this process changing a retirement plan, that's not a quick process, right?

Stacey Tovrov (10:54):

That's exactly right. The process to add an investment menu option or replace an investment option, let alone a QDIA or a default investment menu option can take many quarters. So that's why our kind of comments back to the department of labor in this most recent turn, really focus on providing as much clarity to plan sponsors around considering sustainable or integrating ESG factors or considering sustainable investment options, such that we can hopefully minimize the back and forth that we've seen in years past.

Adam Bass (11:38):

Let's talk about years past and why ESG and retirement funds may have become such a political football. Chris for one, has been working in the sustainability in retirement plan space for a long time.

Chris Walker (11:55):

Where I started my career was with the global reinsurance company, Swiss Re. And at Swiss Re it was great in the sense that I worked on climate and we had experts throughout the house that we had three climatologists on staff, for instance. And so there was never a question around the science, the average employee really embraced the commitments that the company was making on sustainability and climate. And you would think that there would be interest to make sure that the retirement plan was somehow aligned with the institution's investment policies, sustainability, strategy, et cetera.

Adam Bass (12:34):

Spoiler alert, that was not the case.

Chris Walker (12:38):

One of my next stops in my career was at Ernst & Young. And while at EY, there was a statistic that showed that the young accountants were joining EY because of the building a better working world, which was our positioning in the marketplace. And the idea was that it was around value, was particularly around governance. And so I had asked the question about, well, why don't we have a 401(k) that would reflect that? And I was told, no, we couldn't do that because fiduciary duty wouldn't allow us to have anything that was kind of thematic around kind of an ESG issue. And that just struck me as very strange again, because of knowing how these young accountants were potentially voting with their feet as to which firm they wanted to work for because of values.

Adam Bass (13:30):

Chris eventually got a job with New York University or NYU. Stick with me here. I promise this is more than a tour through Chris's resume.

Chris Walker (13:40):

I had taken on a project at NYU when I signed up my first day to the 403(b) plan, I asked explicitly, I would like to have some type of ESG options in my plan. And I was amazed about how difficult it was to identify any type of ESG options in the plan.

Adam Bass (14:02):

And to be clear, you were actually working within something called the Sustainability Institute at NYU, is that right?

Chris Walker (14:09):

Absolutely. So I was motivated.

Adam Bass (14:12):

When we talk about pension plans and retirement accounts especially at a university, how much money are we really talking about? I mean, how does it compare to say a university's endowment, which is where much of the focus tends to go when we talk about universities and investments?

Chris Walker (14:31):

People think of endowments, they think of the big heavy league universities that have huge endowments. But the average university, their retirement plan completely dwarfs the amount of money that they have in their endowments. And there's something like six or sevenfold, or for some of the universities that we've talked to the size difference between the retirement plans and the endowments.

Adam Bass (14:57):

Okay, a lot of money. But why this pattern? Why was it that even if an institution was founded on the ideas of ESG and sustainability, was it unable to reflect that commitment in the single largest pool of investment money under its control?

Chris Walker (15:16):

On a global basis, there was kind of a misunderstanding of whether fiduciary duty allowed planned sponsors to consider ESG. The thinking was, is that some of the ESG plan options were potentially too new or didn't necessarily meet the right criteria and, or whereas imposing perhaps a values basis where their investment performance was really the only potential determining factor. But how do you overcome that considerations of fiduciary duty? There had been a lot of concerns around performance and that whether by considering ESG, you were somehow considering say lesser, the idea being just that ESG somehow meant lesser quality or a lesser issue.

Simone Vergote-Ruiz (16:07):

The whole debate came from the fact that there was a concern that pension fund trustees would be distracted from their core mandate and maybe go to the point that they are not respecting their

fiduciary mandate to the point and sacrifice return, maybe sacrifice also on the risk side. So going into a higher risk assets. And I think all of that is to say that it is from our research, at least not supported this concern. And indeed there is not just a need to limit your financial risk, especially over the time horizons we're talking here, but also to allow for the opportunities to benefit your pension beneficiaries.

On the performance side, what we have seen is that especially the G, so the governance aspect, very easily can be translated into financial metrics and performance. We usually see that companies that perform well on this governance aspect also in the short term, perform better. And on the environmental and the social side is also can spend a bit of a longer time horizon, but especially on the East side, we see that there is a greater data availability now, so you can actually quantify it and you can measure and what you can measure you can manage. So you have a better understanding of this.

Stacey Tovrov (17:32):

We are seeing more of a differentiation between thinking about sustainability, purely from that value-based perspective, and really thinking about sustainability from an investment value perspective. How these material sustainability related insights can help drive better risk adjusted returns and ensure that we can future proof our investment strategies from how markets will evolve in the future or how climate risk will be priced into the markets. That's really the focus that we have when we're talking about sustainability with plan sponsors. Absolutely, there is a natural alignment between participants and different missions and their values with these types of investment strategies. But we want to put investment value at the center of how we position sustainability and how we demonstrate the investment returns that we can generate.

Adam Bass (18:38):

Are plan sponsors or are participants receptive to that idea or?

Stacey Tovrov (18:44):

Yeah. So it's been really interesting to see, right? I think historically we've seen that demand within this space has largely come from some of the largest institutional investors. That's a pretty natural segment of the retirement space to focus on this, but looking beyond defined contribution, certainly endowments, foundation, defined benefit pension plans, insurance companies, those client segments have historically adopted ESG strategies at a much faster rate. But now we're seeing retail investors increasingly allocate to sustainable investments. Last year for example, we've seen asset growth in sustainable mutual funds and sustainable ETF, jumping kind of 22% in 2020 for sustainable mutual funds, ETFs AUM jumped 78% for sustainable ETFs.

And so these are our pretty significant growth figures for a segment that's dominated by retail investors. And so we now believe that this demand is resonating within the defined contribution participant base as well. We conduct an annual survey of plan sponsors and plan participants in the US. And we found that nine and 10 plan sponsors who currently do not offer ESG strategies are considering to do so in the next 12 to 24 months. And furthermore, we see that about 73% of

participants believe that it is important to have an ESG investment option up from 62% in 2019. So again, there is a shift in plan participant behavior as well.

Adam Bass (20:47):

Chris put this another way.

Chris Walker (20:49):

So I'll start off with a caveat here is that, although I'm a lawyer by background, I'm not an ERISA lawyer, but that is my feeling as to just a practical interpretation about how ultimately this will evolve. It will evolve into if you're not considering ESG almost as to why aren't you considering ESG, particularly because it matters for returns. It matters for risk, and it matters for best performance.

Adam Bass (21:21):

What constitutes fiduciary duty? Well, how much time do you have? Now, I don't mean that rhetorically, I mean that literally. What kind of investment horizon are fiduciaries looking at?

Simone Vergote-Ruiz (21:34):

A few years ago when this whole climate rally and when it started treading the financial sector, Mark Carney who was back then the Governor of The Bank of England, he spoke about this tragedy of the horizons whereby it was clear that climate change was a topic affecting everybody. And as a universal investor, you can't divest from it. You're basically exposed to it no matter how diversified your portfolio is. And he said, "Well, if we had a bit of a longer time horizon in our investment philosophy, this would be something we would definitely integrate." And if you look at the pension fund mandates and the time horizon in those spend, it's clear that there is a match between their exposure and their client's exposure to these topics of climate change.

Adam Bass (22:23):

Remember QDIAs back from the beginning, those default retirement investments? Well, a lot of those, a lot are life cycle or target date funds. And this makes sense in a defined contribution landscape, because as I mentioned earlier, it's easy for participants. It's a way to scale from traditionally riskier to traditionally less risky investments as participants approach retirement.

Stacey Tovrov (22:51):

That's where the majority of new dollars are going. The majority of plan participants tend to stay once they're defaulted into those target date funds and we've seen really strong results, right? We do recognize that for individuals having their dollars go into to a professionally managed multi-asset portfolio that de-risks over time as an individual approaches retirement has yielded strong investment outcomes and savings outcomes for plan participants. And so, as a result, we do believe that ESG and the integration of sustainability related insights has a role within a QDIA or within a default investment option like the target date fund. The reason for that is, one, we believe that over the long term material sustainability risks and opportunities can help generate better risk adjusted returns for investors.

And when we think about the long investment time horizon that individual saving for retirement have, that really clearly aligns with the long investment horizon that sustainability risks often play themselves out during. So there's a kind of a natural alignment of that time horizon component that we're talking here. So as a result, many target date funds today may already be considering material ESG insights. But I think that now that the department of labor has allowed for, or at least again removed this specific rule pertaining to QDIA, and we have the same fiduciary standard applying to QDIA as well as the rest of the investment venue, I believe we may see more target date strategies coming to the market that have specific ESG objective.

Simone Vergote-Ruiz (24:58):

From our interaction with clients in the US pension fund clients, we see that the larger ones have already started to pick up on that topic. That is they see this as an emerging trend, as an emerging risk, also as an emerging opportunity. Then there are these initiatives that push more for net zero alignment of corporations and a large part of the financial industry has signed up to this as well. And that might not be so much the driver in the US on the pension fund side, but clearly there is overall a stakeholder interest in this.

Adam Bass (25:32):

It's probably apocryphal, but Winston Churchill allegedly said, "You can always count on Americans to do the right thing after they've tried everything else." So how's America doing on this topic compared to Europe?

Simone Vergote-Ruiz (25:48):

I think they are on a good path. So I would really not dismiss the efforts that are currently being undertaken. I think there is a lot of effort to undo some of the actions of the previous administration and a clear focus on climate in the US right now. And that's something I suppose that the entire financial sector needs to reckon with. And the difference, I think is probably one, from an approach that would say, you are invited to look at this, so it's like an opt in. Two, you are supposed to look at this and if you cannot or it's too burdensome, or if there is no point for you, then you can opt out. And this is a very fundamentally different approach. So what I see in Europe, it's really also starting now in Europe, but the legislation has been put in place. The pension funds know that they will have to look at this in the coming years.

So there is much more of a stronger pull towards ESG integration and pension funds right now. Well, I see the door really opening in the US. And if you look at this next step a bit more in detail, the entire financial market participants, not just pension funds will need to disclose something that's called principle adverse sustainability impact. And that is in fact, something that you declare as a financial sector participant that your company considers the principle adverse sustainability impacts of investment decisions. So the big trend here is, again, that there is a need for pension funds to look at this. And the other interesting aspect is that this actually goes beyond financial materiality. And so I think this is interesting because it has this double materiality approach where you not just look at what is a financially relevant factor, but also what's the impact on sustainability related factors. So this is going well beyond the US approach.

Stacey Tovrov (27:49):

I think that the US is a few years behind Europe in terms of ESG adoption and ESG integration. There's actually a lot of lessons that we've been able to learn from our colleagues in Europe and the UK and apply them to other markets. More and more defined contribution plans in Europe now need to report on their ESG integration status. Two, we're seeing more and more DC plans adopt net zero commitments. And so are now really challenging investment managers to come up with appropriate retirement solutions that have net zero objectives.

And one of the things that we are actively working on right now for our life path portfolios is really thinking about, okay, how do we address a net zero commitment within a target date strategy? Not only just thinking about the underlying building blocks that we invest in, but also more broadly, how we think about glide path construction and strategic asset allocation by incorporating climate aware capital market assumptions, for example. So a lot of, I think really innovative and interesting work that our team is doing in Europe. That, again, as I mentioned at the start, we're learning those lessons every day, watching and observing here in the US. And so hopefully that as the US market evolves, we're going to be ready to address those needs for US plan participants as well.

Adam Bass (29:40):

But getting back to the proposed DOL changes.

Stacey Tovrov (29:44):

Even in anticipation of the new rule, we're seeing a lot of activity from the DC space. We're already seeing a ton of activity from our plan sponsor clients to one, educate themselves and better understand the space and how it's evolved. Two, understand kind of what they own today and what sustainability risks may be highlighted within their current investment lineup and how to address those. And three, looking at the product landscape. So thinking about ways to integrate sustainability within the plan, whether through adding new investment options, replacing existing options, or considering ESG integration as part of the due diligence process. So the rule or the comment period closed in mid-December. Right now, the department of labor is evaluating all of the different comments that the received generally speaking, there was pretty clear consistency and support for the updated rule. And we anticipate sometime later on this year, but hopefully within the first half of the year, we will see an updated and final rule from the department of labor.

Adam Bass (31:04):

After so many years pushing for ESG options and retirement accounts, I had to ask Chris how he was feeling, was he optimistic at this moment?

Chris Walker (31:15):

I have tried not to give you too much of a complex answer here, but I'm quite optimistic if I think about, and just to pick climate as an issue. We need to move much faster as a country and as a planet in essence to address climate. And part of that is going to be having money moved into the right vehicles in the sense that will not potentially exasperate the problem, but potentially be part of the solutions. And retirement plans are huge, I think ERISA plans are close to $10 trillion in the US and the 403(b) side of it is about a trillion dollars. So I think only about 3% of all funds right now, ERISA funds actually have some type of ESG component. And you imagine if that number is 10 or 20 or 30, it starts directionally sending messages both to the companies where ultimately the investment dollars are flowing, but it also helps individuals feel that they're contributing to the solutions and not exasperating the problems.

Adam Bass (32:33):

As we ended our conversation with Chris and his feeling of optimism about where the US retirement space appears to be headed, it reminded me of how often that term is used by our own ESG research team. People like Linda-Eling Lee or Meggin Eastman, when they provided updates on COP26. These are people who spend their days digging into the details of how investors, companies and literally the world is reacting to these environmental, social and governance issues. You'd think or I would anyway that people armed with the facts that they would actually tend more toward pessimism. Maybe the fact that so many don't give into the dark side should bring some light to the rest of us. That's all for this week. A big thank you from Joe and me to Stacy, Chris, and Simone, and to all of you for listening. We'll be back with a new episode and fresh insights in two weeks. Until then, I'm your host Adam Bass and this is MSCI Perspectives. Stay safe everyone.

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