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Debunking ESG myths crucial for DC acceptance — report

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Mikaylee O'Connor said the most important myth to dispel is that ESG means only adding ESG-themed funds.

Defined contribution executives seeking to incorporate ESG principles into their investment lineups must overcome a series of myths that might dissuade them, a new report by the Defined Contribution Institutional Investment Association said.

The report pointed out that environmental, social and governance factors "historically have been misperceived." Today's ESG criteria are more comprehensive than in the earliest days of ESG investing, and they are "increasingly independent of moral stances," wrote DCIIA in the report due out this week.

DCIIA said it's a myth that there is insufficient research to support the concept of sustainable investing. DCIIA also challenged as myth that plan participants aren't interested in this investing approach.

The report also rejected as myths claims that ESG investing is incompatible with fiduciary responsibilities and that adding ESG-themed funds is identical to incorporating ESG principles into investment lineups.

Dispelling that last myth is "most important," said Mikaylee O'Connor, one of six authors of the DCIIA report and a member of the DCIIA executive committee and ESG subcommittee.

"Sponsors think ESG should be an ESG-themed fund," said Ms. O'Connor, a New York-based consultant and head of DC solutions at RVK Inc. "It doesn't have to be all or nothing. I have seen more interest in ESG integration vs. ESG-themed funds."

For example, ESG integration could include asking investment managers about their policies during interviews or in evaluating investment managers.

The DCIIA report identifies ESG integration as having a broad impact because it incorporates ESG criteria for all funds. This strategy requires "a thorough understanding of how ESG factors can be material in investment decision-making," the report said.

This approach is illustrated by the United Nations-endorsed Principles for Responsible Investing, which has been signed by more than 2,000 organizations worldwide, including more than 300 U.S.-based investment managers, the report said.

Citing a list of academic studies, the DCIIA report said there is substantial research to support the value of ESG investing. Research into the relationship between ESG factors and performance "have found a strong correlation with alpha, beta and portfolio value," the report said.

The myth of insufficient ESG research is grounded in the early days of sustainable investing when "divesting was the most common implementation tool," said Anna West, a report co-author and senior vice president and ESG practice leader at Callan LLC.

"There's better, more granular research" today as researchers "put emphasis on risk and return vs. non-financial factors," said Ms. West, who is based in Denver. ESG analyses focus on the "context within the overall strategy of investment managers."

As for the myth that participants aren't interested in ESG investing, the DCIIA report said that because ESG data isn't often marketed to participants, sponsors and investment managers must educate them about the role of ESG criteria in investing.

"Participants may not be vocal about sustainability risks," said Bridget Bearden, a Boston-based consultant to DCIIA who coordinates research at the association. "Not all participants may be fully aware."

The DCIIA report said participants need more guidance and education. "When sustainability is framed as more than just ESG-themed funds, investors agree that these factors should be considered in their investment options," the report said. "Most surveys show that interest (in ESG criteria) is consistent across many demographic segments."

The fiduciary myth surrounding ESG was heightened — mistakenly so, said the DCIIA report — by the guidance issued in April 2018 by the Department of Labor, which caused concern among some retirement industry representatives.

This field assistance bulletin from the Trump administration suggested a more narrow approach to ESG investing in ERISA-covered plans than guidance offered by the Obama administration's Labor Department in 2015 and 2016.

These three guidance documents have "led to confusion due to a lack of clarity in the language and an inconsistent tone over the course of different administrations," the report said.

The 2018 document said, in part, that ERISA fiduciaries "must always put first the economic interests of the plan in providing retirement benefits." It added that plan fiduciaries and investment managers "may not routinely incur significant plan expenses to pay for the costs of shareholder resolutions or special shareholder meetings, or to initiate or actively sponsor proxy fights on environmental or social issues."

However, the 2018 document doesn't overrule the Obama administration guidance, according to the report. "ESG factors remain an appropriate component of a prudent investment decision," the DCIIA report said.

"I don't think it's a shift," said RVK's Ms. O'Connor. "I think it's a refinement. It's prudent to incorporate them into your review of your portfolio."

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