ESG Considerations and the Interplay of Fiduciary Duty

Rebecca O’Brien Radford (Loomis Sayles) & Carlos Joly (CISL)

Contents

UNIVERSITY OF CAMBRIDGE
INSTITUTE FOR SUSTAINABILITY LEADERSHIP

ESG: What can be done consistent with ERISA, part 1?

ERISA requires that fiduciaries be "prudent": "the responsible fiduciary should consider only those factors that relate to the economic value of the plan's investment" *(US Department of Labor Economically Targeted Investment Bulletin*)

- ESG integration contrasts with traditional ethical investment approaches
- Considers factors that implicate economic value of an investment
- Prudence is impacted by the prevailing investment considerations of the time
- "The goal of such ESG integration would be to enhance and supplement (and not replace) an asset manager's investment decision making process" (ie "identify the best possible investments from a risk-return framework, as required by current fiduciary law in the U.S.") (*UNEP FI 2009 Fiduciary Responsibility Report 'UNEP FI Fiduciary II Report'*)
- "Integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and arguably required in all jurisdictions." (*Freshfields Report 2005*)

ESG and the prudent fiduciary

ESG is increasingly included in mainstream considerations impacting an investment's economic prospects

- The foundation is that ESG considerations are risk factors addressing economic risks that may not be appropriately accounted for in traditional public company financial analysis, as well as the identification of investment opportunities associated with issuers demonstrating a positive ESG profile
- "Fiduciaries concerned with long-term preservation and growth of capital should have some understanding of how ESG factors may affect their portfolios." (*UNEP FI Fiduciary II Report, quoting Mercer Investment Consulting, Inc.*)
- "Where ESG factors have the potential to materially impact investment returns we would expect investment managers to be mindful of these issues when making investment decisions as part of their fiduciary duty." (*UNEP FI Fiduciary II Report, quoting Watson Wyatt Worldwide*)
- "Successful investing is dependent upon one's ability to discern the factors that influence the market's valuation of a company and then judge the accuracy of that valuation." (*CFA Institute, July 2008*)
- "Integrating ESG issues into investment and ownership processes […] is necessary to managing risk and evaluating opportunities for long-term investment." (*UNEP FI 2009 Fiduciary II Report*)

ESG: What can be done consistent with ERISA, part 2?

ERISA requires that fiduciaries be "loyal"

- The responsible fiduciary should consider only the beneficiaries of the plan when considering a plan's investments (*US Department of Labor Economically Targeted Investment Bulletin*)
- Practitioners' analyses of long-term value creation (in contrast to short-term volatility bets) increasingly include judgments about ESG factors (e.g., macro and sector analysis considerations of environmental issues, regional economic and social issues) in both equity and fixed income markets

ESG and the loyal fiduciary

Placing current and future beneficiaries' economic interests above any third party interests manifests the duty of loyalty

- "Fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investment on the basis of any factor outside the economic interest of the plan." (*DOL ETI Bulletin, 17 October 2008, DOL Shareholder Rights Bulletin 17 October 2008*)
- DOL has a "longstanding view that workers' money must be invested and used solely to provide for retirements and not for political, corporate or other purposes." (*DOL news release 16 October 2008*)
- Loyal fiduciaries "focus on the value inuring to the beneficiaries and not on achieving unrelated objectives – even if positive collateral benefits result." (*UNEP FI Fiduciary II Report*)
- Thus, for ERISA purposes, ESG matters should be framed within the context of beneficiaries' economic interests and thus actively address and act on investment risks and opportunities associated with ESG matters

What can a trustee do now?

Examples of ways ESG considerations can be addressed by trustees subject to ERISA

- RFPs, Ongoing Due Diligence:
  - Ask how investment managers take into consideration ESG factors in their investment processes: idea generation, portfolio construction (including top-down asset allocation), management and implementation (*Fiduciary II Report*)
  - Ask about investment manager’s ESG policies and competencies
- IMA’s:
  - Require considerations of ESG in investment process – linked to the plan’s economic benefit
  - Require periodic ESG reporting (in asset allocation decisions, investment selection process, impact on investments)

Prudent investing in other contexts

Examples of others' actions on ESG Matters: ERISA's "prudence" needs to consider the current investor landscape

- Endowments:
  - Stanford University divested from coal investments
  - University of California mission to invest in renewable energy sources
  - family office of Standard Oil heirs divested from fossil fuel investments [Gross, Daniel, www.slate.com, Sept. 22, 2014]
  - "Especially given our long-term investment horizon, we are naturally concerned about environmental, social, and governance factors that may affect the performance of our investments now and in the future." (*Faust, Drew: Fossil Fuel Divestment Statement, Harvard University, Oct. 3, 2013*)
- Public Plans: CalPERS "Towards Sustainable Investment & Operations" April 2014: "[Our] Investment Beliefs provide context for CalPERS actions, reflect our values and acknowledge our responsibility as a long-term investor to sustain our ability to pay benefits for future generations."
- UN PRI Principle 4: "promote acceptance and implementation of the Principles [i.e., ESG considerations] within the investment industry."

Biographies

Rebecca O'Brien Radford

Ms Radford is Vice President and Assistant General Counsel at Loomis, Sayles & Company, L.P. Based in Boston, Loomis Sayles has been acting as an investment adviser since 1926, and, as of September 30, 2014, managed approximately $223.2 in domestic and global fixed income and equity assets. Ms Radford provides advice on the wide variety of issues arising at a registered investment adviser, including private fund formation, regulatory and compliance matters. Ms Radford began her investment industry career in 1999, and joined Loomis Sayles in 2011. Ms Radford earned a BA from the University of Illinois at Urbana-Champaign, a License en Droit from the Universite d'Aix-Marseille III (France), and a JD, magna cum laude, Order of the Coif, from Boston College Law School.

Carlos Joly

Mr Joly is an investor with over 20 years' experience experimenting and applying environmental and social criteria in portfolio management. He is currently a Fellow at the University of Cambridge Institute for Sustainability Leadership, and is the architect and prime mover of the Investment Leaders Group. He was Chair of the Scientific Advisory Committee of Natixis Asset Management and designed the Natixis Impact Fund—Climate Change. He is also a co-founder and was Chair of the UNEP Finance Initiative and its Asset Management Working Group for over 10 years. He Co-Chaired the Expert Group that drafted the UN Principles of Responsible Investment and also served on the Commission d´Investissement Socialement Responsable of Paris Europlace-Euronext, and advised the Fonds de Reserve de France on SRI manager selection. Carlos has taught at the Ecole Supérieure de Commerce, Toulouse as Visiting Professor of Finance and Sustainable Development. He has lectured at Oxford, Cambridge, Yale, Kellogg Business School, Haute Ecole de Commerce, Université de Paris-Dauphine, and the Chartered Financial Analyst Institute. He has an A.M. in Philosophy from Harvard University.