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Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210

**RE: RIN 1210-AB95, Financial Factors in Selecting Plan Investments Proposed Regulation**

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the proposed rule “Financial Factors in Selecting Plan Investments.” We bring several perspectives to this comment letter. First, we have a track record of categorizing and rating mutual funds that pursue different sustainability strategies. Second, our equity analysts use environmental, social, and governance (or ESG) analysis as part of their approach to assessing investments. Third, for more than five years we have been using data from Sustainalytics, a leading provider of ESG ratings and data, to analyze issuers and funds.

Simply stated, the Department’s proposed rule is out of step with the best practices asset managers and financial advisors use to integrate ESG considerations into their investment processes and selections. Were the Department to keep the rule as proposed, it would lead to worse outcomes for plan participants as plan sponsors shied away from assessing ESG risks in selecting investments. Indeed, since most participants use qualified default investment options—and ESG considerations would be barred in these options—most participants would not get the benefits that ESG risk analysis can deliver.

ESG risk analysis should be part of any prudent investment analysis—and not called out for special, unique scrutiny. In fact, ERISA fiduciaries should have an obligation to consider ESG risk as it is a pecuniary matter that is fundamental to evaluating the long-term performance of an investment. Firms without a plan to cope with climate change may be caught flat-footed in the face of new regulation or environmental realities. Human capital management is not just about an investor’s preferences, but the pecuniary concern about the reputational and regulatory risks that companies face if

they have poor labor relations. Many large asset managers already integrate ESG factors into their analysis for exactly this reason.

In addition to managing ESG risks, many participants want investment options that match their values. To the extent that plans can offer funds that support these values without sacrificing returns—and we will show that they can—such designated investment alternatives could bring in a new set of investors, furthering the overall goal of enhancing U.S. retirement security.

### Evaluating Long-Term Risks, Including ESG Risks, Is Fundamental to Investing

Morningstar’s long-term investment philosophy embraces the use of ESG factors, as these factors often materially affect a company’s financial performance. We are not unique in embracing these factors, something to which our 3,000 fellow signatories of the Principles for Responsible Investment (PRI), representing more than \$100 trillion in assets under management, can attest. Indeed, ESG investing has gone completely mainstream, as evidenced by the rapid growth in sustainable fund flows. In addition to funds committed to sustainability, many otherwise conventional funds now include some consideration of ESG issues within their investment processes.<sup>1</sup> We call these “ESG consideration funds,” and they invest across a variety of asset classes and implement their goals in numerous ways. Over the past two years the number of ESG consideration funds in the U.S. grew over tenfold, from fewer than 50 at the end of 2017 to over 500 as of December 2019.<sup>2</sup>

As is becoming increasingly common among investment professionals, we believe that to holistically assess a company’s long-term prospects, financial analysts need a view into the sustainability of its business, which determines the likelihood that the firm will continue to generate or expand cash flows. A company’s long-term profitability and growth are consistent with a business model that leads to community well-being, engaged employees, and shared values with customers. Thus, a robust analysis of ESG factors is a critical part of this kind of analysis. A company’s long-term profitability is at risk if it faces ESG risks of which it is unaware or cannot manage effectively. Conversely, a company with limited ESG risks should be better able to maintain or improve its profitability.

Put another way, long-term investing is increasingly about considering the social costs of businesses, which means ESG considerations *are* pecuniary considerations. Indeed, unique among investors, retirement investors have the longest typical time horizons,

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<sup>1</sup> Hale, J. 2020. “The Number of Funds Considering ESG Explodes in 2019.” Morningstar. March 30, 2020. <https://www.morningstar.com/articles/973432/the-number-of-funds-considering-esg-explodes-in-2019>.

<sup>2</sup> Ibid.

often of decades or more. Companies that create negative externalities such as carbon emissions or a poorly paid workforce that relies on public benefits might face risks such as new regulation, poor labor relations, or customer boycotts. Corporations that contribute disproportionately to climate change as a part of their business model will face increasing pressure from regulators to change their practices. On the other side of the ESG coin, companies that do not create these kinds of negative externalities, but are at risk because of them, also need to manage their ESG risk to be sustainable in the long term. Even investors that are focused on shorter time frames need to manage immediate ESG risks such as worker health and safety, product safety and recalls, or business ethics, which, if unmanaged, mismanaged or not addressed, could damage a company's reputation and negatively affect its profits.

None of that necessarily means companies with high ESG risks are inherently attractively priced even after taking ESG risks into account. Further, companies with poor ESG track records can also make rapid adjustments to manage those risks. However, simply ignoring ESG risk is not a reasonable option for many professional investors.

#### [The Proposal Would Put Up Barriers to Considering Information Many Professional Investors View as Material](#)

The Department's proposals would put barriers in place for considering ESG risks, including those that professional investors managing billions in retirement assets consider to be material. This will mean that ERISA fiduciaries would increasingly be out of step with investment professionals who will consider material ESG risks when they evaluate risks, leaving participants in ERISA-covered retirement plans at a disadvantage.

There are no other strategies or kinds of information that the Department singles out for additional scrutiny the way it proposes to single out evaluating ESG data or strategies informed by this data. However, many ESG strategies integrate ESG considerations as part of their investment process to reduce their exposure to risk. In fact, many asset managers also engage with companies on ESG issues to reduce the risks in their funds and improve performance. These funds are making an active bet on ESG factors in the same way that managers make active bets on a variety of strategies or approaches. Indeed, many funds that do not market themselves as ESG funds perform well on our ESG ratings. As detailed previously by the explosive growth in consideration funds, the line between ESG and non-ESG strategies is increasingly blurry. In this context, the additional scrutiny the Department proposes will worsen retirement outcomes as it reduces retirement plan participants' access to a variety of ESG strategies that are designed to improve investment outcomes by accounting for ESG factors.

The theoretical limits of an ESG focus are no different than the limits of any other investment strategy, and indeed, ESG-focused investments have performed well compared with other strategies in recent years. The Department expresses concerns that with “investment funds being offered to ERISA defined contribution plans, fund managers are representing that the fund is appropriate for ERISA plan investment platforms, while acknowledging in disclosure materials that the fund may perform differently or forgo certain opportunities, or accept different investment risks, in order to pursue the ESG objectives.” The same sentence could be written about any other investment strategy—from a strategy focused on issuers with different market capitalizations, to different tilts toward value or growth, or different durations of fixed income. Yet, none of these strategies is subject to additional scrutiny beyond the significant and appropriate requirements embedded in ERISA. The department’s logic is that unlike other objectives, ESG objectives are inherently not pecuniary, but as we have demonstrated, ESG analysis is often integrated into a holistic assessment of a security’s risk and return.

Indeed, ESG-focused funds have generally outperformed conventional fund peers over the past one-, three-, and five-year periods according to Morningstar research.<sup>3</sup> That does not mean that every sustainable fund outperformed, but sustainable large-blend funds have outperformed the S&P 500 net of fees in the past half-decade. Sustainable funds are also more likely to be in the top quartile of performers than conventional funds over these periods.

Similarly, the Department expresses concerns that ESG raters have a wide variety of views on different companies. However, that divergence of views is a benefit, rather than a flaw, of ESG analysis and ESG investing. If every investor agreed on which companies faced what ESG risks, these risks would be fully priced into the securities that these companies issue. Just as portfolio managers hold diverse views on capital market assumptions, company valuations, and growth prospects, different sustainability raters and analysts have different ESG views. These differences make sense, just as it makes sense for different investment analysts to use the same financial information to value equities differently.

The Department’s regulation is fundamentally premised on the question of why a plan sponsor would examine ESG factors when selecting investments, but the question should really be, Why would a plan sponsor avoid considering these factors? The only reason would be the regulatory barriers the Department proposes to erect.

There is increasing consensus that evaluating ESG risks should be a standard part of securities analysis, beginning with the ESG risk an industry or company faces, and then

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<sup>3</sup> Hale, J. 2020. “U.S. ESG Funds Outperformed Conventional Funds in 2019.” Morningstar. April 16, 2020. <https://www.morningstar.com/articles/973590/us-esg-funds-outperformed-conventional-funds-in-2019>

an examination of how well an issuer is managing risk. But a plan sponsor cannot credibly determine whether an ESG factor is pecuniary without examining it. Paragraph c(1) flips this increasingly common approach to assessing the likely risk and return of an investment on its head by requiring that “A fiduciary’s evaluation of an investment must be focused only on pecuniary factors,” while simultaneously asserting that “Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.” This language creates major challenges for plan sponsors looking to mitigate long-term ESG risk in their plans because they cannot determine whether a factor is pecuniary or material without first analyzing it.

The short reference allowing sponsors to consider economic risks or opportunities that qualified investment professionals derive from ESG analysis is little help. First, it follows two sentences that appear to prohibit plan sponsors from considering these factors, and which should be amended to affirm that embedding ESG considerations in such pecuniary analysis is acceptable. Secondly, the reference to generally accepted investment theories assumes a consensus on investing that does not exist for any style. In other words, while many professionals now believe that ESG factors are material, there will always be people who take a contrarian position, as there are with other approaches to investing.

### **DOL Should Not Bar Sponsors From Considering ESG Risk in Qualified Default Investment Alternatives**

Because ESG analysis is so important for developing a view of the long-term sustainability of an investment, ESG investing absolutely should be part of an analysis of qualified default investment alternatives. Should an investment that most participants will use by default at least consider the long-term risks associated with certain ESG practices that could impede an issuer’s long-term ability to generate cash flows and profits, or even stay afloat? We believe the answer is clearly yes, yet the Department seems determined to force participants to simply hope these risks are being managed and analyzed.

This kind of QDIA analysis does not necessarily mean that a sponsor would select QDIAs that included a specific ESG mandate, but that depends on what the Department views as a mandate. For example, the sponsor might examine estimates of the managed and unmanaged ESG risk in the plan’s QDIA, or it might look to have a sleeve of investments in sustainable investments to manage long-term risks. A sponsor might also pick a QDIA such as a target-date fund that considered ESG risks in its security selection without an overall mandate to pursue these strategies. It is not clear if the rule would ban such an investment strategy because the rule is not clear on what does and

does not count as an ESG fund. The Department should at a minimum make it clear that an investment manager's consideration of ESG factors in a strategy would not preclude it from being available as a QDIA. Indeed, paragraph (c)(3)'s prohibition on including strategies that include "one or more environmental, social, corporate governance, or similarly oriented assessments" might prevent a sponsor from examining ESG risk in their QDIA. If this language is not clarified, a sponsor might be barred from offering investment strategies in its QDIA that include a process to examine ESG risks even if the managers of these investments then concluded that the unmanaged ESG risk is appropriately priced into securities. Moreover, as a consequence of the Department's proposal, many of the PRI's almost 600 U.S. signatories, including SSGA, T. Rowe Price, Nuveen, and Eaton Vance, which have committed to integrating ESG factors into their investment decision-making processes, could be curtailed from offering their products through ERISA-covered retirement plans, thereby leading to worse outcomes for plan participants.

Erecting barriers to this kind of analysis ensures that ERISA plan participants are exposed to more ESG risk than they otherwise would be. As a matter of policy, this approach only makes sense if the Department is convinced that ESG risks have been priced into securities, or command a premium in the market, reducing future returns for these investments. The Department has never made such a judgment call about any other investing approach or substituted its judgment for plan sponsors in any other regard. It is unclear if some of the analysis suggested above is not explicitly prohibited, as the department has not provided a clear definition of the kinds of strategies that are not permitted in a QDIA. However, the effect of the regulation will clearly be to scare plan sponsors from including such vital and increasingly important analysis in their plans in general, and in QDIA offerings in particular.

### **DOL Should Not Throttle Designated Investment Alternatives that Offer Competitive Returns and Appeal to Investors Who Want Their Investments to Reflect their Values**

As the Department notes, citing Morningstar data, investors are increasingly interested in sustainability apart from mitigating ESG risk. In the United States, mutual funds focused on sustainable investing attracted more than \$20 billion in assets in 2019, more than 4 times the flows in 2018, as the department noted in the preamble to the rule.<sup>4</sup> Further, investors from all demographic groups report interest in incorporating sustainability into their investment choices. Morningstar's behavioral research team finds that all generations and genders are interested in sustainable investing—as demonstrated in their behavior in a sample allocation decision, as opposed to merely

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<sup>4</sup> Hale, J. 2020. "Sustainable Fund Flows in 2019 Smash Previous Records." Morningstar. Jan. 10, 2020. <https://www.morningstar.com/articles/961765/sustainable-fund-flows-in-2019-smash-previous-records>.

expressing their interest in a survey.<sup>5</sup> Furthermore, Morningstar researchers found that 72% of the U.S. adult population demonstrated at least moderate interest in sustainable investing.<sup>6</sup> A more-traditional survey commissioned by Morgan Stanley similarly found high levels of interest in the U.S. for sustainable investing.<sup>7</sup>

These investors also still strive to realize competitive returns, and, as discussed above, have been able to achieve them with sustainable funds. A growing body of evidence suggests that using sustainable investments generally has not reduced risk-adjusted returns to date. In a recent study, Morningstar researchers found that investors that focus on companies with positive ESG attributes generally do not sacrifice returns, although there may be a small ESG premium in the U.S.<sup>8</sup> A U.S. Government Accountability Office meta-analysis found that 88% of studies of the relationship between ESG factors and financial performance found that using ESG information does not reduce financial returns.<sup>9</sup> In short, picking investments that score better on ESG metrics at the margin or as a tie-breaker is a reasonable strategy for investors who want their investments to reflect their values, and would help encourage some participants to save more through their retirement plans.

Although studies find that an ESG focus has not reduced returns in the past, there is no guarantee that this relationship will continue in the future. Plan sponsors will need to continually monitor their ESG-focused strategies, just as they would any other strategy. For example, as more and more investors look for companies that perform well on ESG metrics, they might increasingly pay a premium to invest in them, reducing future returns. As the Department notes, a strict adherence to ESG criteria can also lead to sector, market-cap, and geographical deviations from the market. However, this need for ongoing monitoring is true for almost any other strategy and already core to ERISA's requirements. There is no need for additional rulemaking to ensure plan sponsors take these responsibilities seriously.

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<sup>5</sup> These researchers asked respondents to choose between investments with lower returns and higher levels of sustainability.

<sup>6</sup> Wendel, S., & Lamas, S. 2019. "Who Cares About ESG Investing?" Morningstar. May 3, 2019. <https://www.morningstar.com/articles/926921/who-cares-about-esg-investing>

<sup>7</sup> Morgan Stanley Institute for Sustainable Investing. 2019. "Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice." [https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable\\_Signals\\_Individual\\_Investor\\_White\\_Paper\\_Final.pdf](https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf)

<sup>8</sup> Sargis, M. "Do Sustainable Stock Portfolios Lead to Lower Returns?" Morningstar. Feb. 20, 2019. <https://direct.morningstar.com/research/doc/967980/Do-Sustainable-Stock-Portfolios-Lead-to-Lower-Returns->

<sup>9</sup> United States Government Accountability Office. 2018. *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would be Helpful*. May 22, 2018. <https://www.gao.gov/assets/700/691930.pdf>



The proposed rule—as is its intent according to the preamble—would make it overly difficult to include sustainable funds as an option for workers, despite the fact that many participants want to invest in such funds and these funds have historically performed well. The rule should be amended to provide more flexibility for fiduciaries to demonstrate that they have selected ESG investments that do not sacrifice risk-adjusted returns. For example, the proposed rule is unclear about whether it would rule out a process that *starts* with plan sponsors that are interested in adding an ESG option from generating a list of investments based on financial factors, and then narrowing that list to ESG-focused funds. This would be a logical approach to adding such designated investment alternatives for plan participants that wish to “do well and do good.” Paragraph (c)(3)(i) should be amended to make it clear that a plan can add a fund as a designated investment alternative because it passes a risk and return screen, and because it might also support other desirable goals.

Furthermore, the “tie-breaker” test, while retained in theory, appears to be unworkable in practice given the Department’s view, as detailed in the preamble, that there will be few, if any, cases of a tie-breaker. However, in practice, many investment funds will have similar risk and return characteristics, levels of diversification, and liquidity. In fact, some of these investments may score well on ESG metrics yet have no mandate to pursue such objectives. Some may score well and have an ESG mandate or incorporate ESG analysis into their approach to selecting securities. The existing tie-breaker test is more appropriate given the realities of ESG investing. Even then, it should be clear that unmanaged ESG risk is a pecuniary concern that need not be subject to the tie-breaker test.

### [The Proposed Rule Would Represent a Sharp Break with the DOL’s Historical Approach to Enforcing Fiduciary Standards](#)

The Department has never opined that an approach to evaluating investment risks is better than any other approach. This proposed rule would do just that: erecting barriers to considering ESG factors that many financial professionals consider as a routine part of investment management and selection. Existing law is sufficient to ensure that fiduciaries select investments that are in their participants’ best interest. Should the Department continue to pursue this regulation, it should, at a minimum, allow ESG funds in QDIAs and allow more flexibility around the process for selecting ESG investments.

Finally, the regulatory impact analysis—which is predicated on a view that ESG investments generally perform worse and plan sponsors will simply avoid such investments—dramatically understates the cost of this regulation to participants and sponsors, as it is based on false assumptions about sustainable investment performance. Many sponsors will still try to consider ESG risk analysis or offer other kinds of sustainable options to their participants. This rule will raise the costs for doing so.



Participants at companies that decide the regulation is too onerous will face worse retirement outcomes if the ESG risks their sponsors decide to ignore manifest and reduce their returns. Such an outcome is not completely assured, but many return-focused investors would argue that it is a strong possibility.

Very truly yours,

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