



Statement before the House Committee on Education and Labor
Subcommittee on Health, Employment, Labor, and Pensions

Improving Retirement Security and Access to Mental Health Benefits

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Chairman DeSaulnier, Ranking Member Allen, and members of the Subcommittee. Thank you for the opportunity to testify today. My remarks will focus on how environmental, social and governance (ESG) considerations should factor into the fiduciary duties that retirement plan administrators and other fiduciaries owe to plan participants.

I wish to start by pointing out the overlooked successes of the U.S. retirement system. Despite claims to the contrary, nearly all indicators of retirement preparedness are pointing in the right direction. Compared to the 1970s, when participation in traditional “defined benefit” pensions peaked at less than 40 percent of the private sector workforce, more Americans are saving for retirement; they are contributing a larger share of their salaries toward retirement; they have amassed over seven times the total retirement savings, with savings increasing among every age, income, educational and racial or ethnic group; they are working longer and delaying claiming Social Security benefits; more retirees are receiving benefits from private retirement plans; retirement incomes are at record highs across the income distribution and poverty in old age is at record lows; and in survey after survey retirees express satisfaction with their financial situations, with 80 percent of retirees telling Gallup they have “enough money to live comfortably” and only five percent of retirees telling a Federal Reserve survey that they are “finding it hard to get by.”

I am not Pollyannaish when it comes to our retirement system. I believe that investment offerings can be improved and fees reduced. But as we consider steps that would affect the system by which Americans save for retirement, we should be conscious of how well the U.S. retirement savings system is currently working and be wary of policies that might undermine these essential programs.

I take no position on the general importance of environmental, social and governance factors, on which informed Americans of good will have differing opinions. Likewise, I express no strong opinions on general public policies that may or may not be enacted to further ESG-related goals, which might include taxes, subsidies, regulations, or even outright bans on certain activities.

My narrow concern is how consideration of ESG factors might affect the U.S. retirement saving system. In particular, I fear that current proposals to give ESG factors greater emphasis in retirement planning could undermine Americans' retirement savings as a means to pursue public policy goals that are distinct from the retirement system and the legal obligations currently placed upon plan fiduciaries.

Sections 403(c) and 404(a) of the Employee Retirement Income Security Act of 1974 (ERISA) require fiduciaries to act solely in the interests of retirement plan participants and for the “exclusive purpose” of providing benefits to participants and beneficiaries and defraying reasonable expenses of plan administration. Various court rulings have eliminated any ambiguity regarding the meaning of these provisions. In the 1983 case of *Donovan v. Mazzolam*, the Ninth Circuit stated that a fiduciary must act with “complete and undivided loyalty to the beneficiaries.” Similarly, in the 2012 case of *Dudenhofner v. Fifth Third Bancorp*, the Sixth Circuit noted that a fiduciary owes a duty of loyalty “pursuant to which all decisions regarding an ERISA plan must be made with an eye single to the interests of the participants and beneficiaries.” Similarly, in the same case of *Fifth Third Bancorp v. Dudenhoeffer*, the Supreme Court of the United States ruled unanimously in 2014 that the benefits of participants, which fiduciaries must treat as their “exclusive purpose,” do not include nonpecuniary benefits, such as broader goals concerning the environment, the economy or society.

More recently, however, policymakers have discussed broadening the criteria to effectively require fiduciaries to consider environmental, social and governance (ESG) factors in guiding portfolio allocations. A proposed rule published in late 2021 by the Employee Benefits Security Administration of the Department of Labor states that a fiduciary’s analysis of potential investments “may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.”¹ The proposed rule, as well as legislation entered by Members of Congress, includes references to investments that are “socially responsible,” “sustainable” and “responsible,” “environmental, social, and corporate governance (ESG),” “economically targeted,” and so forth.

Background. In 2018 the California Public Employees Retirement System (CalPERS), which is one of the world’s largest pension systems, chose to divest from tobacco products. In one sense, this is entirely reasonable: tobacco use literally kills thousands of Americans each day. Yet, in doing so, CalPERS cost its participants over \$3.6 billion in investment gains over the following two decades.² However laudable the broader goal, it is difficult not to interpret CalPERS’s actions as undercutting its fiduciary duty to maximize the financial benefits to the participants of the program, on whose behalf CalPERS collects and invests contributions. The only saving grace is that, since for every seller there also is a buyer, *someone else* whose investments were not controlled by CalPERS made that \$3.6 billion instead.

¹ See “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights.” A Proposed Rule by the Employee Benefits Security Administration on 10/14/2021. <https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights>

² “CalPERS Decision to Divest from Tobacco Is Costly.” Chief Investment Officer Magazine. December 12, 2018.

Could the same thing happen with ESG-oriented investing? It is not hard to imagine that it could, for two reasons.

First, to the degree that ESG factors are relevant to investment returns, there is little reason to assume that market prices do not already capture their effects. The efficient market hypothesis, for which Eugene Fama won the 2013 Nobel Prize in economics, holds that the current price of a stock incorporates all the available information regarding the future cash flows that stock will produce, such as the level and timing of dividends, the risks the firm faces, and so on. It is the rapid incorporation of available information that makes stock prices so difficult to predict, since changes in prices will generally arise only from the incorporation of new or previously-unknown facts. This logic lies behind the decades-long shift of retirement plans from actively-managed investments to passive index funds, a shift that is widely-acknowledged to have been of massive benefit to retirement savers by producing higher returns with lower management fees. As Justice Breyer noted in his unanimous court ruling in *Fifth Third Bancorp v. Dudenhoeffer*, “a major stock market ... provides the best estimate of the value of the stocks traded on it.” The Federal Thrift Savings Plan offers only index funds for precisely these reasons.

The movement to incorporate ESG factors in fiduciaries’ investment recommendations assumes that financial markets’ ability to incorporate myriad types of new information into asset prices for some reason does not work for the laundry list of items the proponents favor. If so, including ESG and related information would increase returns and/or reduce the risk of a plan’s investments. However, I see little reason to assume this is the case. Profit-oriented investors already have incentives to seek out investments that will maximize returns over the long run. Proponents of ESG investment practices have not presented a compelling case that markets cannot or do not take these

factors into account when such factors are likely to influence the returns on a given investment. To be clear, under the proposed rule a given investment cannot be included or excluded simply because it is good or bad when judged by ESG criteria. Rather, those criteria must be shown to impact the returns on such an investment in ways that current market prices have not already anticipated.

In simple terms, if ESG criteria make sense from a purely financial standpoint, then profit-oriented investors will adopt them without being prodded to do so. If ESG criteria do not make sense from a purely financial standpoint, then implicitly promoting them via regulation violates the fiduciary standards set out in ERISA.

Moreover, it is not clear that ESG investing practices would even alter the underlying ESG-related factors that are purported to influence investment returns. Remember that for each seller of a stock motivated by ESG concerns, there will be a buyer of that stock who is likely more focused on the pure financial returns of that asset and who judges that it is a good investment. Again, unless we assume that people who are motivated by environmental, social and governance concerns know something about the market that others do not and are not being swayed by their non-financial concerns about ESG factors, there is little reason to suppose that ESG investing will be superior to other investment philosophies, much less to a passive indexing approach.

Second, assets that may not appear attractive from an ESG perspective may nevertheless have value as part of a larger investment portfolio. For instance, research has found that the returns from energy sector firms have a low correlation with the rest of the market.³ A low correlation to other investments provides diversification that allows for

³ Fischel, Daniel R., and Compass Lexecon. "Fossil fuel divestment: A costly and ineffective investment strategy." Compass Lexecon (2015).

higher returns at lower levels of risk. The inclusion of energy stocks in a broader portfolio has been found to increase the annualized risk-adjusted returns by 0.5 percentage points, which over long periods amounts to a significant difference in the funds available to households in retirement. Thus, a bias against energy-sector investments would tend to harm investors' interests.

In theory, the proposed regulations and legislation are purely informational, and more information makes for more efficient markets. However, plan sponsors and fiduciaries face an increasing number of lawsuits.⁴ And, like physicians who practice “precautionary medicine” to avoid malpractice suits, it is not difficult to imagine that fiduciaries would follow suit with regard to ESG issues. Advisors may recommend steering clear of firms that seem to run afoul of the environmental, social or governance practices dictated by the regulation, even if investing in those firms might be in the financial best interest of their clients.

I find it difficult to accept this is not the intended effect of proposals that would require fiduciaries to consider and produce a report on, among other things: economic factors such as local job creation and affordable housing; employee treatment factors such as health safety, diversity, demographics, human rights, the right to collectively bargain, prevention of discrimination and child labor, and supply chain management; environmental considerations such as climate issues, species endangerment, environmental justice, worker transitions with respect to the shift to a low carbon economy; and governance considerations such as executive compensation and board diversity.

⁴ For instance, see J.D. Supra. “Supreme Court Declines to Close Floodgates on 401(k) and 403(b) Fee Litigation.” January 28, 2022. <https://www.jdsupra.com/legalnews/supreme-court-declines-to-close-1375430/>

Moreover, there are reasons to fear that a reliance on ESG investments could materially harm the retirement savings of U.S. investors. The precursor to ESG investing was socially or economically targeted investments designed, for instance, to spur local economic growth. ESG investing has become a major factor only in recent years. However, researchers at the Center for Retirement Research (CRR) at Boston College looked at the

Table 1. Annualized returns on ESG and Vanguard funds by asset class, 10 years through 2020.

	ESG	Vanguard	ESG minus Vanguard
Bond (short)	3.5%	2.7%	0.8%
Bond (long)	4.5%	8.1%	-3.6%
Equities (large cap)	11.6%	14.0%	-2.4%
Equities (mid cap)	10.1%	12.5%	-2.4%
International	7.2%	10.8%	-3.6%
Real estate	2.4%	9.7%	-7.3%

Source: Center for Retirement Research at Boston College.

effects of social investing and ESG investment practices on state and local government pension investment returns over the period 2001 to 2018. The CRR study’s authors found that “state mandates and ESG policies reduce annual returns by 70 to 90 basis points... The negative relationship

between state mandates and returns in both equations is consistent with the results of earlier studies.”⁵

The Boston College researchers also compared the returns on a variety of ESG funds to those of Vanguard index funds covering similar asset classes. With the exception of short-term bond funds, the Vanguard index funds handily out-performed competing ESG funds, by an average of over three percentage points per year. Much of this difference was due to ESG fund’s substantially higher fees, though substantial performance differences existed even prior to fees being deducted. Indeed, part of the appeal of ESG

⁵ Aubry, Jean-Pierre, Anqi Chen, Patrick M. Hubbard, and Alicia H. Munnell. "ESG Investing and Public Pensions: An Update." Center for Retirement Research at Boston College State and Local Pension Plans 74 (2020).

funds to the investment community may rest on fees: in an era when index funds have driven fees practically to zero, special-purpose investment vehicles such as ESG funds are likely to be far more profitable to the financial industry.

Recent research from the Employee Benefit Research Institute has found that women and employees with low account balances are more likely to choose ESG funds in defined contribution plans.⁶ If these funds do not produce the same risk-adjusted returns as non-ESG funds – and there is reason to fear they will not – then these groups would be made financially worse off and gender and income inequality in retirement savings may be increased.

While the proposed DOL rule purports that ESG factors may not detract from the priority given to risk and return in choosing investments, the inherent subjectivity of these newly-added criteria make treating them as “tiebreakers” difficult or impossible. For instance, over the past 10 years, the Vanguard S&P 500 index fund (VFINX) has a mean annualized return of 16.39 percent, a standard deviation of annual returns of 13.20 percent, a Sharpe ratio of 1.11 and a Sortino ratio of 1.81. All of these figures could be taken beyond two decimal points of precision.⁷ What are the chances of a true “tie” between this investment and an ESG-based alternative?

Moreover, even in the unlikely case of a tie, a prudent advisor would inquire as to the possibility of an actively-managed fund producing higher returns net of fees in future years. According to Wharton School professor Kent Smetters, over a 10-year period actively managed funds focusing on mid- and large-cap stocks underperformed a passive index fund 97 percent of the time. And even the three percent of funds that outperformed

⁶ Bearden, Bridget and Michael Gropper. “ESG Investment Options in Public DC Plans.” EBRI Issue Brief. February 24, 2022.

⁷ The Sharpe and Sortino ratios are measures of an investment’s return relative to its risk.

the index over a 10-year period tended to underperform the index in following years.⁸ In general, any actively-managed fund is a risky bet versus a passive fund, and particularly so if we have reason to believe that the markets may already have incorporated the effects of the ESG factor on future returns.

Concluding remarks on ESG. One does not need to be a denier of man-made climate change or indifferent to social and governmental issues to believe that ESG-driven investment practices may be harmful to investors. One must only believe that when investment is directed at goals other than maximizing the financial gains to savers, that savers' financial interests may be harmed.

Under ERISA, the American saving for retirement comes first. My concern with some proposals regarding ESG investing practices is that, over time, the retirement saver could come third: first would come the public policy interests favored by Congress, followed by the financial interests of fiduciaries who may fear being sued if they do not sufficiently promote those goals. Only then would come the interests of investors. That is not an outcome that would serve Americans well.

It appears that the goal of ESG standards is to raise the cost of capital for firms that do not follow the environmental, social or governance practices that the sponsors of such regulations and legislation favor. If that is what Americans in fact wish to do, there are much more direct and efficient ways to do so, such as explicit taxes on activities we disfavor and subsidies for activities we favor. Government does that all the time. But if Americans don't wish to enact such taxes or subsidies, or at least not in sufficient

⁸ The Wharton School, University of Pennsylvania. "Active vs. Passive Investing: Which Approach Offers Better Returns?" <https://executiveeducation.wharton.upenn.edu/thought-leadership/wharton-wealth-management-initiative/wmi-thought-leadership/active-vs-passive-investing-which-approach-offers-better-returns/>

numbers that Congress is able to pass legislation to that effect, then perhaps we shouldn't be doing them. And, more strongly, I believe we should not be doing them by the back door in a way that may violate the spirit, and potentially the letter, of the law.

Comments on Discussion Draft of Retirement Legislation

In this section I offer specific comments on several issues raised in the Majority's discussion draft of retirement-related legislative provisions.

Section 5, Automatic re-enrollment. This section requires that, when employers use automatic enrollment in retirement plans, an employee who affirmatively declines to participate must restate that decision not to participate every three to five years or otherwise be automatically re-enrolled. These policies must balance questions of how long an employee's decision is deemed to last – does “No” mean “No”? – versus the general benefits to retirement income security of automatic enrollment. While granting the trade-offs, employees should be clearly presented with the option to remain outside of the employer's retirement plan. Most workers do need to save for retirement on top of Social Security, and employer sponsored plans generally offer both a tax benefit and an employer-match, which is effectively “free money” to the employee.

Section 6, Employee ownership and participation initiative. This section would establish a grant program to promote Employee Stock Ownership Plans (ESOPs), in which employees purchase or are granted shares in their employer's stock. While ESOPs are helpful in increasing employees' voice at work and in aligning economic incentives between workers and management, I am not sure whether a new federal promotional program is needed. More generally, I would not wish to see ESOPs expand at the expense of 401(k)s or other retirement plans. A worker preparing for retirement

generally wishes to diversify between his labor income and his savings, since if his employer goes bankrupt, he does not wish to risk losing both.

Section 7, Rainy Day Savings. This section incorporates H.R. 4986, the *Refund to Rainy Day Savings Act*, which facilitates the establishment of “rainy day” savings accounts run by the U.S. Treasury Department and funded with a portion of tax refunds that individuals otherwise would receive. While I favor work to encourage rainy day savings accounts, where possible I would tend to favor doing so as “side car” accounts alongside 401(k) plans rather than through accounts run by the federal government. Section 7 also reauthorizes an expanded Assets for Independence (AFI) program, which facilitates the establishment of Individual Development Accounts (IDA). While I favor IDAs as a way to build financial capacity and establish a broader ownership society, the AFI program itself was found by HHS to be “slow to obligate funds and demonstrate results.” Therefore I suggest that Congress consider these provisions carefully before moving forward.