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Financial Factors in Selecting Plan Investments

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General Comment

This is wrong on so many levels and you should hear more voices on the subject. I am a 3(21) Fiduciary advisor to US retirement plans and have worked with SRI now ESG or Sustainable investing for over two decades. ESG has been showing performance and and sometimes decrease risk in portfolios. Since employees are oftentimes times more worried about losing money than making money (behavior finance 101), managing risk may be in the best interest of participants. Making ESG a riskier choice for employers may actually increase risk, not decrease it, for employees. Here are important facts to consider- (per Harvard Low School Forum on Corporate Governance - "DOL Proposes New Rules Regulating ESG Investments" posted by Martin Lipton- Wachtell, Lipton, Rosen & Katz, on Tuesday, July 7, 2020. LINK: <https://corpgov.law.harvard.edu/2020/07/07/dol-proposes-new-rules-regulating-esg-investments/>)

- The Broader investor community recognizes that ESG is about "value and performance"
- ESG Investments are fundamentally driven by expected financial returns, including considerations regarding long term value, opportunity and risk.
- Studies have been cited/published over the past five years indicating that an ESG perspective can improve performance
- Certain studies have shown that ESG focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility
- Investors who screened for ESG factors could have avoided 90% of S&P 500 bankruptcies from 2005 to 2015
- S&P 500 companies in the top 25% by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25%
- Amid the current pandemic, ESG fund have demonstrated out performance relative to the

market and continue to attract strong inflows

Bottom line: If the proposed rules are adopted, ESG investment options will likely become more difficult to offer under a 401(k) plan.

Please expand the comment window on this important consideration.

Attachments

DOL Proposes New Rules Regulating ESG Investments

SustainableInvestingCovid-19_client LPL Research

SustainableInvestingPrimer_ClientUse LPL

Harvard Law School Forum on Corporate Governance

DOL Proposes New Rules Regulating ESG Investments

Posted by [Martin Lipton](#), [Wachtell, Lipton, Rosen & Katz](#), on [Tuesday, July 7, 2020](#)

Tags: [Corporate Social Responsibility](#), [DOL](#), [ERISA](#), [ESG](#), [Fiduciary rule](#), [Institutional Investors](#), [Retirement plans](#), [Securities regulation](#), [Sustainability](#)

More from: [Alicia McCarthy](#), [Carmen Lu](#), [David Kahan](#), [David Silk](#), [Martin Lipton](#), [Sabastian Niles](#), [Wachtell Lipton](#)

Editor's Note: [Martin Lipton](#) is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, [David M. Silk](#), [David E. Kahan](#), [Sabastian V. Niles](#), [Alicia C. McCarthy](#), and [Carmen X. W. Lu](#). Related research from the Program on Corporate Governance includes [The Illusory Promise of Stakeholder Governance](#) by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum [here](#)) and [Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee](#) by Robert H. Sitkoff (discussed on the Forum [here](#)).

As ESG investing continues to accelerate, the Department of Labor (“DOL”) has [proposed for public comment rules](#) that would further burden the ability of fiduciaries of private-sector retirement plans to select investments based on ESG factors and would bar 401(k) plans from using a fund with any ESG mandate as the default investment alternative for non-electing participants. The proposal asserts that “ESG investing raises heightened concerns under ERISA,” and, in contrast to the broader investor community’s recognition that ESG is about [value and performance](#), and despite growing evidence that the investment returns of ESG funds can outperform those of non-ESG funds, the proposal reflects the DOL’s continued concern that ESG investment might “subordinate return or increase risk for the purpose of non-pecuniary objectives.” In terms of defining what would be an ESG-themed fund or mandate triggering heightened scrutiny and procedural requirements, the proposed rule casts the net widely to reach those featuring “one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name.” Such assessments and judgments have, of course, become common and mainstream, with investors, companies and fiduciaries of all kinds bringing their business determinations to bear.

The proposed rules would prohibit a retirement plan fiduciary from making any investment, or choosing an investment fund, based on the consideration of an environmental, societal or governmental factor unless that factor independently represents a material economic investment consideration under generally accepted investment theories or serves as a tiebreaker in what the DOL characterizes as the rare case of economically equivalent investments. In order to select an investment with an ESG component, the plan fiduciaries would be required to compare investments or strategies on “pecuniary” factors such as diversification, liquidity and rate of return. Specific documentation would be required for the tiebreaker justification and for the selection and monitoring of an investment alternative in a 401(k) plan that includes ESG in its mandate or fund name. Most significantly, the proposed rules would prohibit a 401(k) plan from providing a qualified default investment alternative (“QDIA”) with an ESG component, no matter how small, even if that investment alternative satisfies the pecuniary factor requirements.

Numerous sophisticated investors have indicated that their ESG investments, social benefits notwithstanding, are fundamentally driven by expected financial returns, including considerations regarding long-term value, opportunity and risk, and have cited studies published over the past five years indicating that an ESG perspective can improve performance, including studies that show [ESG-focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility](#), and investors who screened for ESG factors could have [avoided 90% of](#)

S&P 500 bankruptcies from 2005 to 2015 and that S&P 500 companies in the top 25% by ESG ratings **experienced lower future earnings-per-share volatility than those in the bottom 25%**.

Amid the current pandemic, ESG funds have demonstrated **outperformance** relative to the market and continue to **attract strong inflows**, which appears to reflect growing investor recognition of the importance of ESG in risk management and mitigation, as well as the view that addressing ESG issues promotes long-term value creation. It is particularly anomalous, especially in these times, for the DOL to limit or unduly burden the ability of plan fiduciaries to exercise a judgment that items like good corporate governance, effectively navigating energy transitions or operating in a sustainable manner can enhance or protect returns.

If the proposed rules are adopted, ESG investment options will likely become more difficult to offer under a 401(k) plan, leading to less availability to plan participants of ESG investment alternatives as part of their retirement portfolios. The extensive scope of criteria that the DOL considers problematic will also likely result in increased costs and fees as plan fiduciaries seek to filter for these criteria. The rule may also have broader ramifications for the asset management industry which has actively integrated ESG into its product offerings. Increased scrutiny and litigation can also be expected relating to plan investments in funds that make investment decisions with reference to ESG metrics driven by stakeholder, rather than financial materiality.

At the same time, if implemented, the new rules may spur further demand for comparable, decision-useful ESG data to help satisfy the burden imposed by the DOL to justify the inclusion of ESG factors in private-sector retirement plans. The rules may also accelerate the work being done in business schools, academia, investment houses and sophisticated finance and valuation venues to measure ESG's impact and ensure that generally accepted investment theories do not have value-relevant ESG blindspots. With investors continuing to pour capital into ESG and increasing evidence of ESG outperformance, it remains to be seen whether the DOL proposal will be a deterrent to the entry of ESG into mainstream investing outside of the private retirement plan arena. And as companies are well aware, investors will continue to use ESG-related screens and factors to inform proxy voting decisions on individual directors and proposals in both contested and uncontested situations, prioritize engagement requests and decide when and whether to escalate matters with a given portfolio company, whether publicly or privately.

The comment window on the DOL's latest proposal closes on July 30, 2020.

Trackbacks are closed, but you can [post a comment](#).

Promoting Positive Change Through Investments

The Impact of COVID-19 on Sustainable Investing

The past couple of months have been challenging as the world struggles to adapt to the spread of the COVID-19 virus. The health crisis has directly impacted millions, and mitigation efforts to slow the spread have led to an aggressive slowdown in economic activity due to significantly lower consumption and other economic disruptions.

Within this setting, clients who have demanded greater transparency about how and where their money is invested have seen their investments perform better than conventional approaches while at the same time knowing their investments are promoting positive change. For many of today's investors, the way they invest matters, and sustainable investing offers the opportunity to build wealth responsibly without sacrificing investment principles.

In the midst of the COVID-19 global pandemic, sustainable investing

continues to be a force for positive change—changing the investment industry, improving companies, and helping communities.

Investment Industry

Sustainable investing has helped change the investment industry by challenging, and then adapting, traditional approaches in the investment decision-making process, while creating greater transparency and adding investment options in the process. Formalized in 2006 under the United Nations-backed Principles of Responsible Investment (PRI), which seeks to advance the integration of

environment, governance, and social (ESG) issues into investment decision-making, this type of investing has attracted over \$30 trillion in assets under management.¹

During the first quarter of 2020, sustainable investing equity funds held up better than their conventional peers. Seven out of 10 sustainable equity funds finished in the top halves of their Morningstar Categories, and 24 of 26 ESG-tilted index funds outperformed their closest conventional counterparts.²

Contributors to outperformance included a higher allocation to high-



¹ Global Sustainable Investment Alliance, 2018

² "Sustainable Funds Weather the First Quarter Better Than Conventional Funds," Morningstar, April 3, 2020

Promoting Positive Change Through Investments

quality companies (as measured by strong financial statement metrics such as low debt and higher return on equity), and a lower allocation to energy. A primary feature of sustainable investing strategies is what is referred to as ESG incorporation, or incorporating ESG issues when building investment portfolios. This process leads to an emphasis on companies that exhibit better ESG ratings relative to their peers. These companies typically have fewer hidden risks (referred to by investors as off-balance sheet liabilities) and are more resilient to unexpected events (referred to by investors as black swans).

The fact that sustainable funds have been holding up well in this market makes sense considering those funds with better ESG ratings relative to their peers have given thought to and developed policies

around environmental concerns, such as resource depletion; social concerns, such as employee relations; and governance concerns, such as board diversity and structure. Having transparency and policies around these concerns exemplifies long-term planning and preparation for all different types of contingencies.

While the depth and breadth of outperformance during the first quarter was impressive, it may be surprising that it is consistent with longer-term performance as well. The MSCI KLD 400 Social Index—an index of 400 US securities that provides exposure to companies with strong relative ESG ratings and excludes companies whose products have negative social or environmental impacts—has outperformed the S&P 500 Index since its inception May 1, 1990.

If an investor had placed \$10,000 in the MSCI KLD 400 Social Index on May 1, 1990, it would have grown to \$175,430, compared with \$156,480 if invested in the S&P 500 Index over that same time period. This is equivalent to an annualized return of 10% for the MSCI KLD 400 Social Index versus 9.6% for the S&P 500 Index.

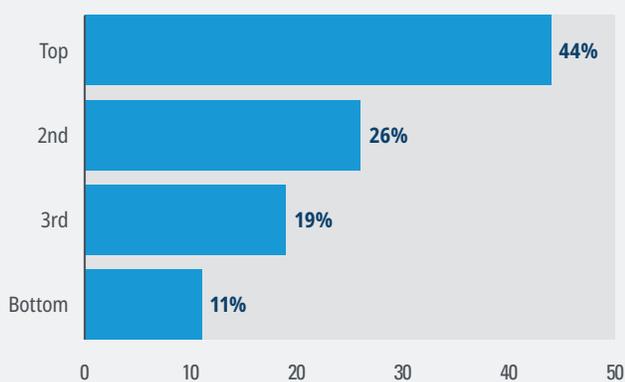
In addition to holding up better than conventional funds during the first quarter of 2020, flows into sustainable investing funds set a record, eclipsing the previous record set in the fourth quarter of 2019.³

Companies

Sustainable investing can also be seen making improvements within companies themselves through shareholder engagement. Active engagement by shareholders can encourage more responsible corporate practices while discouraging corporate

1 SUSTAINABLE EQUITY FUNDS

Q1 2020 Return Rank % by Morningstar Category Quartile (206 Funds)



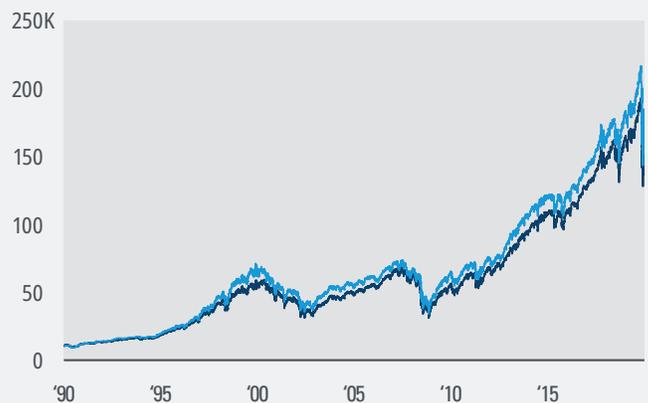
Source: Morningstar Direct 03/31/20

Oldest shareclass used for mutual funds. N=206

Past performance is no guarantee of future results.

2 MSCI KLD 400 SOCIAL INDEX VS. S&P 500 INDEX

● MSCI KLD 400 Social Index ● S&P 500 Index

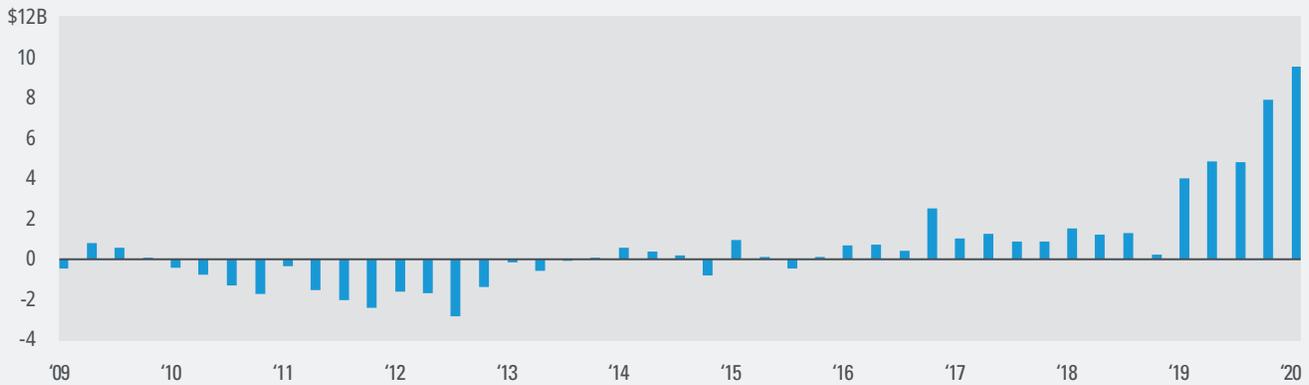


Source: Morningstar Direct 04/21/20

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

³ "Despite the Downturn, U.S. Sustainable Funds Notch a Record Quarter for Flows," Morningstar, April 9, 2020

3 U.S. SUSTAINABLE INVESTING FUNDS ESTIMATED QUARTERLY FLOWS



Source: Morningstar Direct 03/31/20
Includes open-end and exchange-traded funds available to US investors.

practices that may lead to increased exposure to risk.

In the early stages of the COVID-19 global pandemic, sustainable investors used their relationships with company management for the benefit of the greater good. Recognizing that the long-term viability of the companies in which they invest is inextricably tied to the welfare of companies' stakeholders—including their employees, suppliers, customers, and the communities in which they operate—sustainable investors urged the business community to take specific actions.

One group, led by Domini Impact Investments, Interfaith Center for Corporate Responsibility, and the Office of the New York City Comptroller—which included 195 investors representing nearly \$5 trillion—provided a benchmark for the business community on topics such as paid leave, health and safety of workers, supplier/customer relationships, and financial prudence.⁴

Communities

Sustainable investing has also been at work positively changing communities through community-oriented investing. This type of investing brings capital directly to underserved communities that conventional markets do not reach, such as low-income neighborhoods and rural communities.

One approach is to invest in government-backed securities that target low- and moderate-income communities, which offers both the potential for social benefits to underserved communities and economic advantages to investors. A pioneer in the field, Ron Homer at Access Capital Strategies (now RBC Global Asset Management), created customized mortgage pools backed by Fannie Mae to help provide capital to underserved communities. In order to meet various reporting requirements, Ron's granular approach has been able to identify specific benefits from this investment

method, including providing more than 14,000 mortgages for low- and moderate-income home buyers, more than 55,000 affordable rental units, and more than 6,000 nursing home facility beds.⁵

While the economic impact of COVID-19 on communities as a whole will be substantial, those who were financially vulnerable prior to the pandemic will be disproportionately affected. Without a paycheck, low- and moderate-income workers are unlikely to be able to pay their housing costs, will fall behind on basic bills, and may not even be able to put food on the table for their families. Ron's strategy has a significant allocation to agency mortgage-backed securities (MBS) where the underlying loans are made to homeowners making less than 80% of area median income. As part of the stimulus package, mortgage giants Freddie Mac and Fannie Mae have instructed lenders to be more flexible with borrowers, allowing forbearance or modified payment plans. This

⁴ "Investor Statement on Coronavirus." Domini. March 26, 2020

⁵ RBC Global Asset Management, as of September 30, 2019.

Promoting Positive Change Through Investments

provides much-needed relief to the same individuals this strategy seeks to support. At the same time, the agency backing of the underlying loans provides investors with assurance that regardless of divergence from standard payment schedules, they will continue to receive the expected principal and interest each month.⁶ As a result, the strategy's holdings of primarily AAA-rated agency-backed securities have held up much better during the recent market volatility, while many other areas of the bond markets, such as corporate and high-yield bonds, declined.

⁶ RBC Access Capital Strategy Update. RBC Global Asset Management. April 1, 2020.

Bottom Line

The past couple of months have been challenging as the world has struggled to adapt to the spread of the COVID-19 virus. Within this setting, clients who have demanded greater transparency about how and where their money is invested

have seen their investments perform better than conventional approaches while knowing their investments are promoting positive change. In the midst of the COVID-19 global pandemic, sustainable investing continues to change the investment industry, improve companies, and help communities.



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. There is no assurance that the products or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

Sustainable investing is subject to numerous risks, chief amongst them that returns may be lower than if the advisor made decisions based only on investment considerations.

All performance referenced is historical and is no guarantee of future results. Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

Any securities discussed in this material for illustrative purposes should not be construed as investment advice or recommendations for your clients.

In an effort to distinguish funds by what they own, as well as by their prospectus objectives and styles, Morningstar developed the Morningstar Categories. While the prospectus objective identifies a fund's investment goals based on the wording in the fund prospectus, the Morningstar Category identifies funds based on their actual investment styles as measured by their underlying portfolio holdings (portfolio and other statistics over the past three years). See Morningstar Category for Funds Definitions (April 2020) for further details.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

MSCI KLD 400 Social Index is a capitalization weighted index of 400 U.S. securities that provides exposure to companies with outstanding environmental, social, and governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts. The parent index is MSCI USA IMI, an equity index of large, mid and small cap companies. The Index is designed for investors seeking a diversified benchmark composed of companies with strong sustainability profiles while avoiding companies incompatible with values screens.

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Sustainable Investing: A Force for Positive Change

Sustainable investing is a force for positive change. While regional terminology may differ, sustainable investing is an approach that incorporates environmental, social, and governance (ESG) issues when building an investment portfolio, while encouraging companies to improve their ESG risk-management practices. Interest in sustainable investing continues to grow, which can be measured by the remarkable growth in assets under management (AUM) of more than \$30.7 trillion.¹ In the process, sustainable investing has changed the investment industry, improved companies, and helped communities. These extraordinary outcomes are aligned with the basic intention of sustainable investing: to build wealth responsibly without sacrificing investment principles.

investment decision-making process. This process evolved slowly at first, starting when the Pax World fund, which excluded manufacturers of weaponry from its portfolio, launched in 1971 and became the first sustainable investing mutual fund. Other large investors began to follow Pax, and instances of divestiture grew, as manufacturers of tobacco and companies with operations in Apartheid-era South Africa were removed from investment portfolios. Divestiture, or excluding securities from an investment universe on the basis of standards and norms, is the oldest sustainable investing method.

By the late 1980s, two small companies emerged to carry the transition beyond this primary method of sustainable investing. Both companies began gathering data that allowed

investors to build an investment universe on the basis of a company's ESG data and then compare this data relative to peers, which ultimately merged "value-driven investors" with "values-driven investors."

Value(s)-driven investors. In 1985, Innovest Strategic Value Advisors, Inc. (Innovest) began using its proprietary analytics platform to assist clients in uncovering hidden risks and value potential in companies that conventional securities analysis could not detect, a focus commonly desired by *value-driven* investors. In 1988 Kinder, Lydenberg, Domini & Co. (KLD) was founded with a mission to remove barriers to socially responsible investing and influence corporate behavior, a focus commonly desired by *values-driven* investors. In 2010, MSCI purchased both Innovest

Changing the Investment Industry

Sustainable investing has positively changed the investment industry by challenging and then adapting traditional approaches of the



¹ Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review (2018)." <http://www.gsi-alliance.org/trends-report-2018/>

Sustainable Investing: A Force for Positive Change

and KLD, forming MSCI ESG Research, which has become the world's largest ESG-rating data source. It currently provides ratings on 7,500 companies and more than 650,000 equity and fixed income securities.²

While Innovest, KLD, and other similar companies were collecting ESG data, the actual "ESG" usage didn't appear until a 2004 United Nations Global Compact report titled, "Who Cares Wins: Connecting Financial Markets to a Changing World." The report sought to "develop guidelines and recommendations on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services, and associated research functions."³

In 2005, the United Nations Environmental Program's Financial Initiative's (UNEP-FI) "Freshfields Report" discussed at length the financial relevance of ESG data and the concern of fiduciary duty in the use of ESG data in the investment decision-making process.⁴ This concept was later updated to state that "the fiduciary duties of investors require them to incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons."⁵

These two reports became foundational pieces of the UN-backed "Principles of Responsible Investment

(PRI)," which was launched in 2006. The initial group of 18 signatories⁶ has evolved into a thriving global initiative with more than 2,400 members representing over \$86 trillion in AUM. The UN-backed PRI's role is to advance the integration of ESG issues into the investment decision-making process, following a set of six investment principles in which signatories agree to:

1. Incorporate ESG issues into their investment analysis and decision-making processes
2. Be active owners and incorporate ESG issues into their ownership policies and practices
3. Seek appropriate disclosure on ESG issues by the entities in which they invest
4. Promote acceptance and implementation of the Principles within the investment industry
5. Work together to enhance their effectiveness in implementing the Principles
6. Each report on their activities and progress toward implementing the Principles.

With more investors adopting the UN-backed PRI and increased ESG data availability, ESG issues increasingly are being considered when building an investment portfolio. This sustainable investing

Environmental factors may include climate change, deforestation, pollution, resource depletion, and water; social factors may include child labor, employee relations, human rights, modern slavery, and working conditions; governance factors may include bribery and corruption, board diversity and structure, executive pay, political lobbying and donations, and tax strategy.

² <https://www.msci.com/esg-ratings>

³ https://www.unglobalcompact.org/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf

⁴ Freshfields Bruckhaus Deringer and United Nations Environment Programme Finance Initiative, "A Legal Framework for the Integration of Environmental, Social, and Governance Issues into Institutional Investment" (2005). http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

⁵ United Nations Global Compact, UNEP Finance Initiative, PRI. "Fiduciary Duty in the 21st Century." 2019.

⁶ Original signatories included: Amalgamated Bank, Amundi, Aviva Investors, Bank J. Safra Sarasin Ltd, BNP Paribas Asset Management, BMO Global Asset Management, British Columbia Investment Management Corporation, Calvert Research and Management, Daiwa Asset Management Co. Ltd, Domini Impact Investments, Generation Investment Management LLP, Groupama Asset Management, Hermes Investment Management, Insight Investment, Janus Henderson Investors, Mitsubishi UFJ Trust and Banking Corporation, Sumitomo Mitsui Trust Asset Management, Threadneedle Asset Management Ltd.



Sustainable Investing: A Force for Positive Change

process, known as ESG incorporation, can be applied using a combination of three primary strategies:

- **Integration.** Involves the explicit and systematic use of ESG issues in investment analysis
- **Screening.** Involves the application of filters to a list of potential investments based on an investor's preference and includes both negative/exclusionary and positive/best-in-class screening
- **Thematic.** Involves the use of traditional financial analysis coupled with an intention to contribute to a specific ESG outcome and includes sustainability-themed and impact/community investing.

Growth in sustainable investing.

Growth in sustainable investing has been remarkable, as shown by more than \$30.7 trillion in AUM pursuing these strategies in mutual funds, exchange-traded funds (ETF), separate accounts, and accredited investment vehicles. Positive/best-in-class screening and sustainability-themed strategies are the fastest growing strategies, with recent annual growth rates of 50% and 92%, respectively. In terms of size, negative/exclusionary screening is the largest—and oldest—strategy,

while ESG integration is the second largest—although it recently has been growing more than twice as fast as negative/exclusionary screening.⁷

A combination of client demand, increasing recognition that ESG factors can affect risk and return, and regulation is driving the growth of sustainable investing. Investors are increasingly demanding greater transparency about how and where their money is invested. For today's investors, the way they invest matters.

In addition, there is growing recognition that ESG factors can influence investor returns. An analysis of more than 2,000 academic studies on how ESG factors affect corporate financial performance found an overwhelming majority of positive outcomes.⁸ Another analysis concluded that 80% of academic studies show that stock price performance of companies is positively influenced by good sustainability practices.⁹

Since the mid-1990s, sustainable investing regulation has provided more guidance on the consideration of ESG factors in the investment process. Globally, there are more than 730 hard- and soft-law policy revisions

across some 500 policy instruments that support, encourage, or require investors to consider long-term value drivers, including ESG issues.¹⁰

Improving Companies

Sustainable investing has positively changed companies through the practice of shareholder engagement, which encourages more responsible corporate practices while discouraging corporate practices that may lead to increased exposure to risk. While the growth of shareholder engagement began in the mid-1970s, it wasn't until it was codified in the UN PRI that shareholder engagement really took root. Since then, shareholder engagement has been a driver behind some significant corporate policy changes, including increased corporate disclosures, a key element in the ESG integration process. In addition, recent research illustrates that shareholders that engage with companies on ESG issues can create value for both investors and companies by exchanging information, producing and diffusing knowledge, and building relationships.¹¹

⁷ Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review" (2018). Available at <http://www.gsi-alliance.org/trends-report-2018/>

⁸ <https://download.dws.com/download?elib-assetg-uid=714aed4c2e83471787d1ca0f1b559006&wt-uid=2156623951900953270&wt-t=1566240624353>

⁹ Gordon Clark, Andreas Feiner, and Michael Viehs. "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Performance." (Oxford University and Arabesque Partners, 2014). September 2014.

¹⁰ United Nations Global Compact, UNEP Finance Initiative, PRI. "Fiduciary Duty in the 21st Century." 2019.

¹¹ <https://www.unpri.org/academic-research/how-esg-engagement-creates-value-for-investors-and-companies/3054.article>



Why Sustainable Investing Matters

Interest in sustainable investing continues to grow, with more than \$30.7 trillion in AUM. Client demand, increasing recognition that ESG factors can affect risk and return, and regulation are driving the growth.

A 2017 study by the Morgan Stanley Institute for Sustainable Investing found high levels of interest in sustainable investing among individual investors:



75%

of all respondents—and **86%** of millennials—were interested in sustainable investing.



80%

were interested in sustainable investments that can be customized to meet their interests and goals.



71%

believed that companies with leading sustainability practices may be better long-term investments.

Similarly, a 2016 survey by Natixis Global Asset Management of participants in 401K and other defined contribution plans found:



82%

of respondents said they want investments in their retirement plan that reflect their personal values.



62%

of plan participants said they would increase their contributions if they knew their investments were doing social good.



74%

would like to see more socially responsible investments in their retirement plan offerings.



64%

of all respondents were concerned about the environmental, social, and ethical records of the companies they invest in.

Sustainable Investing: A Force for Positive Change

Shareholder engagement can be applied using a combination of four primary strategies:

- **Proxy process.** This allows shareholders to engage with a company on its ESG disclosure, policies, and practices through shareholder resolutions and proxy voting. A shareholder resolution is a proposal submitted to a company to be voted on by all shareholders at the annual shareholder meeting. Shareholders can then vote on resolutions through proxy voting. Investment advisers who vote their client proxies have a fiduciary duty to vote proxies in their client's interests.
- **Dialogue.** Communicating with a company to demand changes in practices that impact ESG issues may include direct dialogues with the company, participating in multi-stakeholder initiatives, and taking collective action with other investors.
- **Policy.** Shareholders may attempt to influence governmental regulations to require companies to improve their ESG impact. This may include asking companies to be a public voice for a policy, submit public testimony, and encourage regulatory bodies to codify best ESG practices.
- **Assertive action.** This includes taking legal action or creating a public campaign (i.e., divestment) to force or pressure a change in company behavior. Examples include organizing divestment campaigns and pursuing a seat on the company's board of directors.

Investment managers, often with the cooperation of other investment managers and non-profit organizations such as Ceres, As You Sow, and the Interfaith Center on Corporate Responsibility, have helped

companies address ESG risks while also identifying ESG opportunities within their business practices. Some high-profile shareholder engagement examples include:

- In 2015, Domini Impact Investments (Domini), Trillium Asset Management (Trillium), and Friends of the Earth engaged with a large home improvement retailer to eliminate from its stores neonicotinoid pesticides, which are leading contributors to global bee population declines. The shareholder proposal, submitted by Domini and Trillium, asked the company's board of directors to conduct a risk assessment of its environmental protection policies and practices to determine whether continued sales of neonicotinoid-containing products were in the best interests of the company, its consumers, and its shareholders. The investors withdrew the shareholder proposal in response to new commitments, as the company announced it will phase out neonicotinoids as suitable alternatives become available.¹² Another large home improvement retailer quickly followed suit.

- In 2015, Pax World was the lead filer of a shareholder proposal at a large consumer electronics retailer, and co-filed shareholder proposals at two large e-commerce retailers, requesting disclosure of the results of pay equity assessments. As a result, the large consumer electronics retailer announced the results of the company's gender pay assessment at its annual meeting that year and stated that the company is committed to closing the pay gap.¹³
- In 2016, Trillium announced the successful withdrawal of its shareholder proposal at a large apparel retailer, based on the company's commitment to report on the actions it has taken to identify and curtail human rights risks in its supply chain. Trillium first filed this proposal when a large apparel retailer reported that it sourced nearly half of its private-label product from factories that were at risk of human rights violations.¹⁴

¹² <https://www.domini.com/insights/>

¹³ <https://impaxam.com/news-and-views/>

¹⁴ <https://trilliuminvest.com/>



Helping Communities

Sustainable investing also has positively changed communities through community-oriented investing, which brings capital directly to underserved communities, such as low-income neighborhoods and rural communities that conventional markets do not reach. It also involves delivering explicit social benefits, such as affordable housing and small business loans, using an investment product that can be managed for risk and return. Community investing can be accomplished primarily through cash, fixed income, and private equity asset classes.

Investors can engage in community investing through Community Development Finance Institutions (CDFIs) that specialize in serving low-income communities. First established in the 1970s and certified by the US Treasury Department, CDFIs are private intermediaries that provide capital and technical assistance to communities and people underserved by conventional lending institutions. CDFIs fall into four basic categories: community development banks, community development credit unions, community development loan funds, and community development venture capital. A very common community investment practice is to place cash on deposit in CDFI banks or credit unions.

Additional fixed income options for community investing include promissory notes and government bonds for housing and other activities in Community Reinvestment Act (CRA) geographies. Promissory notes offer investors market-like returns while providing capital to a diversified portfolio of intermediaries and funds that are investing in communities

left out of traditional capital markets. These notes help finance projects that may include affordable housing, community development, education, environmental sustainability, health, renewable energy, small business, and sustainable agriculture.

Certain investment managers have developed market-rate fixed income strategies that focus on community development by investing in high-quality mortgage-backed securities backed by US federal agencies. One pioneer in the field, Ron Homer at Access Capital Management, created customized mortgage pools within CRA geographies and backed by Fannie Mae to help provide capital to underserved communities. In order to meet various reporting requirements, Ron's granular approach has been able to identify specific benefits from this investment method, including providing more than 17,000 mortgages for low- and moderate-income home buyers, more than 93,000 affordable rental units, and nearly 6,000 nursing home facility beds.

Next Steps

Sustainable investing will continue to be a force for positive change in the investment industry, corporations, and our communities. Understanding the sustainable investing impact can help you better understand where and how your money is invested.

Prior to considering investment options, you may want to consider your motivations for sustainable investing. Identify the ESG issues that most resonate with you. This process will help you learn more about the issues and help you narrow down and identify investment services that best match your investing principles.

To invest in a manner that contributes to positive change, that is appropriate for your age, investment objectives, risk tolerance, and return objectives, you may want to consult your LPL financial professional.



Sustainable Investing: A Force for Positive Change

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

Sustainable investing is subject to numerous risks, chief amongst them that returns may be lower than if the financial professional made decisions based only on investment considerations.

All company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

Alternative investments may not be suitable for all investors and involve special risks such as leveraging the investment, potential adverse market forces, regulatory changes and potentially illiquidity. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Investing in mutual funds involves risk, including possible loss of principal.

Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus and, if available, the summary prospectus contain this and other important information about the investment company. You can obtain a prospectus and summary prospectus from your financial representative. Read carefully before investing.

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