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Socially Responsible Investing: Investing with a Conscience

As plan sponsors focus on their retirement plan fund lineups, they must carefully consider the types of investments to offer. Their options cover a wide range: core asset classes, such as stable value or mid cap growth; alternative asset classes, like emerging markets or real estate investment trusts; or differently structured options, such as asset allocation funds (Target Date Funds, risk-based funds). An additional question is whether the plan sponsor should offer funds that invest in companies that act with a social conscience – should a fund array include investments in "responsible funds"?

Interest in responsible investments has expanded significantly over the past several decades. The first responsible investing mutual fund was the Pioneer Group, which started in 1921. Over time, other fund managers adopted similar investment practices and began to offer investors choices of fund options. In the mid-1990s, there were 60 responsible mutual funds available, according to Morningstar. Today, The Forum for Sustainable and Responsible Investment (www.ussif.org) lists 146 funds covering all major asset classes.

Types of Responsible Funds

The description "responsible investing" is fairly broad. As more mutual funds have emerged in this sector, these funds have become classified into different areas of specialty based on their screening methodology. The three main categories are:

- Socially Responsible Investing (SRI) – a process that uses ethical guidelines to avoid investing in certain companies, by using negative screening;
- Impact Investing – a system of investing in companies that actively pursue social and environmental change; and
- Environmental, Social and Governance investing (ESG) – a process of screening companies in which to invest by incorporating environmental, social and governance aspects into the company analysis.[1]

While SRI was the most popular form of responsible investing, its processes, along with those of Impact Investing, impose constraints. SRI & Impact Investing specifically use the values of the investor/organization to determine in which companies to invest. This results in a significantly restricted pool of potential companies from which to choose, because their operations must be consistent with a particular social mission.

[1] *From SRI to ESG: The Changing World of Responsible Investing,* Commonfund Institute, September 2013

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ESG Investing is not mission-based. It is used as a tool to augment the investment return of a portfolio. By seeking to identify companies whose performance is enhanced by its attention to ESG factors, an investment manager can develop a strategy for long-term profitable returns in addition to social good.

Problems with Responsible Investing

FIDUCIARY RESPONSIBILITY

A concern with offering responsible investment mutual funds is the potential to generate lesser investment returns than those of other non-responsible funds in the same asset class. The reason for the concern is that the managers of the responsible investment funds have to eliminate from consideration certain potential companies, due to their business models, governance policies or specific industry. They will therefore be precluded from the same level of success as those managers who are not restricted by similar limitations. Historical data from Morningstar indicates that while many of these responsible funds excel in their asset categories, on average, responsible funds do lag their non-responsible fund counterparts by a small margin.

Based on data through March 31, 2014, an analysis of all of the responsible funds listed in Morningstar, inclusive of each share class of each fund, yields 484 funds with Morningstar Star ratings. The average Star rating for responsible funds is 2.7, or just slightly below the midrange, with 41% of the funds holding 1-star or 2-star ratings (the lowest) versus 22% holding a 4-star or 5-star rating (the highest). In addition, the most recent 3-year period shows 56% of the funds ranked in the 3rd or 4th quartile, with an average category ranking of 55. Over the most recent 5-year period, only 51% appear in the 3rd or 4th quartile, with an average category ranking of 52.

For retirement plan sponsors, this may pose a potential problem. The fiduciaries of a retirement plan governed by ERISA have a responsibility to ensure that the investment options offered in the plan are competitive. That does not mean that they must always select the top performing fund in each asset class, but the funds selected must be reasonably similar and competitive to the associated benchmark and the median performance for the asset class.

Plan fiduciaries can expect no relief from this standard just because the fund operates with a social conscience. In 2008, the Employee Benefits Security Administration re-affirmed that characteristics beyond the fundamental risk and return profile of the fund may not be used as a factor in selecting investments: "In deciding whether and to what extent to make or refrain from making a participant investment, a fiduciary may only consider factors relating to the interests of plan participants and beneficiaries in their retirement income."[2]

[2] Advisory Opinion 2008-05A

DIVERSIFICATION

Another matter for plan sponsors to determine, when they incorporate responsible investments in a fund lineup, is how best to enable a participant to fully diversify his/her account, using only responsible investments. Most participants who opt for responsible investments are 100% socially conscious; they want to be able to allocate their entire portfolio among responsible investments. If the fund array only offers one responsible fund in an asset class that is either all equity, such as Large Cap Blend, or all fixed income, such as Intermediate Term Bond, the lineup would not allow full diversification using only responsible investments. The participant would be too heavily allocated towards just one asset class.

As a result, if plan sponsors are going to offer only one responsible investment option, many elect to provide a balanced fund, or an allocation fund. If the plan sponsor is going to offer a pure equity option, then they will typically also present a pure bond option as well, to allow for diversification. The problem with this model is that if one of those funds underperforms to the point that it requires replacement, it must be replaced by another responsible fund in that same asset category. The more specialized the asset class, the fewer replacement options available.

UNDERLYING SOCIAL CRITERIA

Not all responsible investments employ the same criteria for the selection of responsible companies. Even funds that fall under the same broad category, such as SRI or ESG, may use widely disparate screening systems and principles. These divergences in the funds' criteria may derive from religious or ethical ideals that may not align with either the plan sponsor's preferences or those of its participants. This can be another limiting factor in either the initial selection of a responsible fund, or the search for a replacement fund. Not only must the plan sponsor committee find a responsible investment option in the appropriate asset class, but it may also seek to find a fund that fits its particular social agenda.

COMPARING PERFORMANCE

The difficulty of comparing performance between responsible funds poses another challenge. Once the asset class has been selected and the non-responsible funds have been screened out, how do the remaining funds compare to one another in performance? Do the variances in return reflect the judgment of the manager and his/her investment selections, or is it a function of the screening criteria? Given the limited number of responsible investments in each asset class, once the screening criteria are compared with each other, are any two funds truly alike and suitable for an "apples to apples" comparison?

Potential Solutions

So what is a plan sponsor to do? How can a plan sponsor offer diversification within responsible investments which meets the competitive standard and the screening criteria, without putting the plan fiduciaries at risk?

Vigilance in the due diligence process for fund selection is obviously critical. Close monitoring on an ongoing basis is also important. In addition, one possible way to accommodate this is by offering a Self-Directed Brokerage Account (SDBA). Plan sponsors can provide participants with access to the universe of responsible investments, either SRI, ESG or Impact Investing funds, in a SDBA without incurring a fiduciary oversight necessity (at least they can for now – see below).

A drawback, however, is that the SDBA is most appropriate for an investment savvy participant, or for someone working with an investment adviser to recommend investment selection. These windows make available mutual fund investments of all shapes and sizes. That breadth can tempt the novice investor into allocating his/her account into risky options that have not been vetted by the plan sponsor investment committee. This might not lead to the best outcome for the participant's retirement account. In addition, the Department of Labor (DOL) has on its agenda for 2014 to take another look at the usage of these brokerage windows in Defined Contribution retirement plans, which could impact the current lack of a fiduciary oversight requirement. (As I said above, "for now.")

Plan sponsors using a tiered array structure for their fund lineup have been exploring another route, of placing these options into the bottom tier. In a typical 3-tiered investment array, the first tier is a Target Date Fund series intended to capture the majority of participants, particularly those with less investment experience and knowledge. The second tier is usually a core array of investment choices, often including a mix of actively managed and indexed mutual fund options, to allow participants to develop a diversified asset allocation on their own. (Some plan sponsors use a 4-tiered array with Tier 2 being all indexed funds, and Tier 3 being all actively managed funds.)

The bottom tier is typically either a SDBA, or an expanded array of investment options for which the plan sponsor expressly states that it is not conducting due diligence. Thus, participants who are allocating towards these investments are on their own. A plan sponsor could include a diversified array of responsible investment options in that bottom tier, allowing for socially conscious investors to select funds that align with their goals, while not subjecting the plan sponsor to the required fiduciary oversight of the funds in the other tiers.

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This solution may be viable, particularly for plans not subject to ERISA. For plans subject to ERISA, it is unclear whether or not this latter model can be used. Although a plan sponsor may state in its Investment Policy Statement that the investments in the bottom tier are available for investment, but will not be reviewed and vetted by the plan fiduciaries, there is no guarantee that the DOL will approve that arrangement. The DOL could take the position that the investment is subject to the same requirement for scrutiny and oversight as any other investment in the overall lineup. Since this strategy has not been fully tested or challenged, it is critical that plan sponsors speak with their plan legal counsel to review the concept before implementing such a program.

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