LAZARD
ASSET MANAGEMENT

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Filed Electronically

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

Re: *RIN 1210-AB95, Financial Factors in Selecting Plan Investments*

Dear Madam or Sir:

Lazard Asset Management LLC ("LAM") respectfully submits the following comments regarding the above-referenced proposal to amend the Investment Duties rule under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). *See Financial Factors in Selecting Plan Investments*, 29 CFR Parts 2509 and 2550, RIN 1210-AB95 (June 22, 2020), 85 Fed. Reg. 39113 (June 30, 2020) (the "Proposed Release").

LAM is pleased that the Department recognizes the accelerating demand for integrating environmental, social and governance ("ESG") considerations in investment products available to those saving for retirement. The Proposed Release appears not to be founded upon the most current research, and is instead based on negative assumptions about the impact of ESG considerations on investment outcomes. As set forth in this comment letter, LAM believes that ESG considerations can help manage investment risks and propel investment returns. Due to its flawed assumptions, we believe that the Proposed Release would impose unnecessary restrictions and burdens on plan fiduciaries considering the addition of ESG investment options to ERISA-regulated retirement plans. We further believe that the proposed rule, if adopted, would be detrimental to the long-term investment returns experienced by qualified plan participants and their beneficiaries.

A. Background

LAM is an investment adviser registered with the Securities and Exchange Commission, with more than $170 billion of assets under management as of March 31, 2020. We manage assets on a discretionary basis for a large number of global clients, including a variety of U.S. defined benefit plans, defined contribution plans and individual retirement accounts. LAM also manages collective investment trusts that appear as investment options in qualified retirement plans and mutual fund portfolios that are investment options in variable annuity programs.

LAM is a fiduciary that offers actively managed investment strategies to its clients. Our investment decisions are based upon proprietary fundamental and quantitative research techniques that our professionals have developed over decades, which are subject to robust risk management and supervisory procedures.

Our firm seeks to manage client portfolios in a way that delivers investment performance, maximizes long-term shareholder value, and limits unwanted risks. LAM has not embedded ESG into its investment processes for the political or marketing benefits alluded to in the Proposed Release. Rather, LAM believes ESG considerations will help our investor portfolios outperform over time, and in these comments we are providing some of the research that supports our approach.

B. Comments to Proposed Release

The Proposed Release would amend ERISA Rule 404a-1, which sets forth the standards of prudence that an ERISA fiduciary must satisfy when selecting investments for a qualified plan. Under the existing rule, a fiduciary satisfies the standard by giving "appropriate consideration" to a particular investment or investment course of action. *See* Rule 404a-1(b)(1)(i). This effort includes, among other things, reaching a conclusion that the investment is reasonably designed to further the purposes of the retirement plan, following appropriate review of the risks, the opportunity for investment gains and other factors. A number of Department bulletins and pronouncements have effectively guided plan fiduciaries that have chosen to consider adding ESG investment options to their plans pursuant to Rule 404a-1. *See e.g.* Interpretive Bulletin 2008-01, *Interpretive Bulletin Relating to Investing in Economically Targeted Investments*, 73 FR 61734 (Oct. 17, 2008); Interpretive Bulletin 2015-01, *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments*, 80 Fed. Reg. 65135 (Oct. 26, 2015); and Field Assistance Bulletin No. 2018-01 (April 23, 2018).

The Proposed Release would remove some of the discretion that plan fiduciaries currently have to select investments incorporating ESG considerations and would discourage those fiduciaries from using their remaining discretion to add ESG investments. For example, one of the key proposed changes to Rule 404a-1 would deem a fiduciary's duties of prudence and loyalty "satisfied in connection with an investment decision" if in addition to other requirements the fiduciary makes its decision "based solely on their pecuniary factors and not on the basis of any non-pecuniary factor." 85 Fed. Reg. at 39117. The proposed rule also would add a new provision making it "unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or other non-pecuniary goal." *Id.* And while the Proposed Release concedes that ESG factors themselves "may be economic considerations," under the rule such factors only could be treated as such "if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories[]," which the release does not attempt to define. *Id.* Under the proposed rule, fiduciaries would not be allowed to employ an investment incorporating ESG considerations as a qualified default investment alternative, or "QDIA," in a qualified plan. A fiduciary which seeks to select a non-QDIA investment that incorporates ESG factors under the Department's "all things being equal" test would be required to document its rationale in detail.

LAM believes that restricting and discouraging fiduciaries from adding ESG investments to qualified plans would detract from plan investment performance over the long-term. We also believe that the Department's rationale for the proposed rule does not reflect the asset management industry's current approach to ESG investing or the research supporting that approach.

1. ESG Considerations Create Pecuniary Benefits for Investors

Research has shown that the stock prices of issuers that score high on sustainability considerations, and that successfully manage material environmental and social risks and opportunities, have generally outperformed others over the long-term. A recent analysis of data from MSCI shows how the ESG considerations cumulatively contributed 1.88% to the top 20 ESG funds' returns over the last ten years, with more than 80% of that return occurring in the last four years of the study period. Similarly, Goldman Sachs' recent research shows that ESG investing "leaders" consistently outperform ESG laggards[1] resulting in an additional 320bps in total shareholder return ("TSR") over the 8-year period between 2012 and 2020. Goldman Sachs' research also finds that companies with poor ESG management (*i.e.*, those that experience ESG "controversies") tend to underperform on a forward looking basis over 1 and 3 years on a relative TSR basis.

New research also suggests that ESG investments can provide investors with levels of pecuniary protection during periods of market turbulence. For example, S&P Global Market Intelligence recently found that funds investing in companies based on their ESG ratings were "relative safe havens in the economic downturn." It analyzed the performance of 17 ESG-focused exchange-traded and mutual funds with more than $250 million in assets from Jan. 1 through May 15 of this year. All but three outperformed the S&P 500 index, widely considered one of the best representations of the overall U.S. stock market.

In *Corporate Sustainability: First Evidence on Materiality*, a paper published in 2016[2], the authors use materiality classifications to present evidence on the value implications of sustainability investments. Using both calendar-time portfolio stock return regressions and firm-level panel

[1] GS Sustain, The PMs Guide to the ESG Revolution (April 18, 2017)

[2] Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.

regressions, the researchers find that firms with good ratings on material sustainability issues significantly outperform firms with poor ratings on these issues. In contrast, firms with good ratings on immaterial sustainability issues do not significantly outperform firms with poor ratings on the same issues. These results are confirmed when they analyze future changes in accounting performance.

A more recent academic publication, *Better Fewer, But Better: Stock Returns and the Financial Relevance and Financial Intensity of Materiality*[3], investigates the role of the financial relevance and financial intensity of ESG materiality on stock market performance. Building on the previous empirical evidence that ESG financial materiality has a positive impact on financial performance, this paper aims at assessing whether quantity and quality of materiality can represent an additional input in the selection and optimization of a financial portfolio. Using the identification of industry-specific material issues provided by the Sustainability Accounting Standards Board (SASB), this paper introduces the concept of the financial relevance and financial intensity of ESG materiality in order to estimate how it explains equity returns. The results of this analysis, based on a large sample of U.S. companies included in the Russell 3000 from January 2008 to July 2019, show that not only does ESG performance have a positive effect on stock returns, but also that, when financial relevance and financial intensity of materiality is taken into account, the market seems to reward more those companies operating in industries with a high level of concentration of ESG materiality.

As an asset manager that has incorporated ESG considerations into its proprietary research, LAM is able to regularly provide our clients with examples of how such considerations have positively influenced investment outcomes. Our sector-based approach to ESG integration is based on the Sustainability Accounting Standards Board's ("SASB") foundational approach to materiality assessment, and helps us identify, prioritize and price ESG risks and opportunities on a forward-looking basis. Our proprietary materiality assessments create investment insights at both the sector and issuer level. In 2019, we had over 45 frameworks published on LAM's internal research database that attempt to decompose oft-considered non-pecuniary concerns such as climate change and increasing social inequalities with the goal of feeding such analysis into our financial models and valuations[4]. Some of the frameworks developed to analyze material human and natural capital considerations include:

[3] Better Fewer, But Better: Stock Returns and the Financial Relevance and Financial Intensity of Materiality (April 12, 2020).

[4] https://www.lazardassetmanagement.com/docs/-m0-/106599/annualsustainableinvestmentreport2020_en.pdf, page 12-35

- Plastic packaging: A framework to assess the impact of product substitution for packaging companies with high exposure to plastics, that also includes a scenario analysis tool to quantify its range of impacts on earnings;
- Carbon tax: An automated tool to model carbon intensity by sector and geography allowing analysts to quantify the potential costs of carbon under different price scenarios around the world;
- Physical risks of climate change: A framework to assess the resilience of cement company assets to increasing levels of drought, flooding, higher sea-levels and wildfires around the world;
- Cyber-security risks: Precedent analysis to determine the level of uptick in cyber-security related expenses, post a breach, and potential impact on future financial productivity;
- Financial inclusion: A framework to uncover the opportunities that emerge from greater financial inclusion of communities in emerging markets by analyzing metrics across customer type and breadth of financial products;
- Access and affordability of healthcare: A time series analysis of net pricing trends and resulting ranking system to identify those companies most at risk of deteriorating financial returns that informs our relative valuation process.

We believe that the long-term pecuniary benefits, along with the desire on behalf of investors to support corporate sustainable practices without sacrificing investment returns, account for why the Department has observed the increased investor demand for ESG investment options.

2. The Proposal Does Not Reflect Contemporary ESG Investment Capabilities

Underlying the Proposed Release is the Department's apparent view that ESG investments not only produce lower investment returns – but that they place style over substance, charge elevated fees, and generally raise "heightened concerns under ERISA." 85 Fed. Reg. at 39115. Respectfully, such a conclusion disregards facts concerning what ESG investing is today, and how professionally managed ESG portfolios are currently researched and constructed. Indeed, the Proposed Release's view also is at odds with the Department's 2015 Interpretive Bulletin on the subject, which noted that

> Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.

Interpretive Bulletin 2015-01, 80 Fed. Reg. at 65136.

ESG investing, also known as sustainable investing, began as a series of investor efforts designed to influence certain corporate behaviors. In its early stage, it largely focused on the exclusion from investments of certain business activities like gambling, tobacco and alcohol. Since then it has evolved substantially. It has extended beyond investment exclusions to encompass fundamental research and analysis of market-based environmental and social opportunities, which at firms like LAM are incorporated into valuations and financial forecasts. It also includes sophisticated assessments of investment risks that can enhance investor adjusted returns and "future-proof" portfolios for 21st century challenges. ESG investing has progressed to the point where professional managers like LAM have dedicated significant resources to focus on the development of new ESG research techniques, managing ESG-related risks, and complying with global ESG investment regulations. The Proposed Release does not recognize this evolution, but many others have.

Indeed, assessing the investment risks and opportunities related to climate change – one of the key focuses of sustainable investing – has been acknowledged by governments and regulators as being of increasing importance to financial market stability. For example, in June 2020, the Network for Greening the Financial System (NGFS), a network of Central Banks and financial Supervisors stated that

> More frequent or severe extreme weather events and/ or a late and abrupt transition to a low-carbon economy could have significant impacts on the financial system, with potential systemic consequences. Extreme weather events could lead to damage of physical assets, including real estate, productive capital and infrastructure, and loss of life with consequent property and casualty insurance losses, damage to balance sheets of households and firms, increases in defaults, and potential financial sector distress. A late and abrupt transition to a low-carbon economy could lead to a sudden repricing of climate-related risks and stranded assets, which could negatively impact the balance sheets of financial institutions.

NGFS Report, *The Macroeconomic and Financial Stability Impacts of Climate Change: Research Priorities*, page 4.[5] The NGFS Report also finds that "[a]ssessing the impact of climate physical and transition risks on the financial system is one of the most urgent and prominent issues." *Id.* LAM agrees and believes that incorporating fundamental ESG research on climate change into our investment decision making will help to protect members of retirement plans from being negatively exposed to these types of risks. The absence of such ESG considerations could leave our clients exposed to those risks.

As consumers and businesses favor more sustainable products and services, and governments adopt policies designed to promote the same, a company's sustainable practices are likely to impact its financial productivity and the valuation of its marketable securities. We believe fundamental analysis with ESG considerations provides a more holistic view of the quality of a portfolio company, and how long it can maintain high returns on capital, than analysis without ESG

[5] NGFS, The Macroeconomic and Financial Stability Impacts of Climate Change: Research Priorities, June 2020

considerations. LAM's research has identified significant overlap between quality businesses with high cash flow-return-on-invested-capital and those with strong ESG scores[6]. That is why LAM actively encourages our investment professionals to take ESG considerations into account when managing client assets. This may include seeking to anticipate the amount and timing of the loss of cash flows related to climate change (for example), as well as the nature and timing of policy makers' response to these risks in the form of new regulations and fiscal policies. As set forth in LAM's *Climate Change Investment Policy*, we believe that the transition to a lower-carbon economy could also present investment opportunities for our clients.

For these reasons, we believe that excluding assessments of material ESG issues in retirement plan investments is inconsistent with the goals of ERISA. The risks identified by an ESG-integrated assessment are often ultimately detrimental – while the opportunities identified can be additive – to the financial performance and value of assets in an investment portfolio.

C. Conclusion

We believe that this rulemaking effort is unwarranted for at least two reasons.

First, the Proposed Release is based upon incorrect assumptions about the impact of ESG considerations on investment outcomes. If the proposed rule is adopted, we fear that U.S. plan participants would be unjustifiably exposed to the financial impacts of long-term systemic risks like climate change, companies on the wrong side of social trends, and companies with poor governance practices – and to the negative investment results that those exposures create, which is contrary to the result the Department is trying to achieve.

Second, we believe that the existing fiduciary standards under Rule 404a-1 and the guidance previously issued by the Department sufficiently protect plan participants when their fiduciaries are selecting ESG investments for qualified plans. Our experience with plan fiduciaries interested in ESG investing is that they are fully capable of recognizing whether an investment incorporates genuine ESG research, and whether that research can enhance retirement outcomes. We recognize the Department's desire to protect retirement investors from investment products that promise to deliver pecuniary and non-pecuniary outcomes, but do the latter in a way that is hard to measure at the expense of the former. However, the capabilities of professional ESG investors have progressed substantially over the years. The current market for investment strategies that incorporate ESG considerations is evolving very quickly, and we believe that it is becoming highly competitive and efficient.

[6] See "The Link Between ESG and Financial Productivity," Lazard Perspectives, 25 June 2018.

In light of the foregoing, we recommend that the Department postpone any action on the Proposed Release and instead conduct a full analysis of the nature of modern ESG investing, its benefits to plan participants, and the costs of excluding ESG investment options from plan portfolios.

We would be happy to provide the Department with additional information concerning our comments. Any requests should please be directed to our General Counsel, Mark Anderson, who may be reached at (212) 632-1890 or mark.anderson@lazard.com.

Respectfully submitted,

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