Fiduciary "Best Interest" Accounts for Plan Participants' Risk Preferences – Shouldn't It Also Justify ESG Preferences?

Founded in 2014, Capital Preferences is an independently owned decision science technology and research firm created by globally acclaimed economists. We appreciate the opportunity to comment on the proposed regulation and commend the Department for reconsidering the existing regulation, which we believe was based on incorrect economic assumptions about ESG investing.

Summary

We are writing to inform the Department with regard to economic research on how to measure and quantify the economic principle of "individual utility benefit" derived from a participant's portfolio alignment to ESG causes. Today, new techniques exist that reveal the utility that plan participants derive from ESG aligned investing. We believe the Department and plan fiduciaries are well served by including individual utility terms, as well as performance benefits, as part of the evaluation of ESG investments. We encourage the Department to incorporate sound economic theory that demonstrates utility improvement for the individual investor as a justification for allowing ESG investing in accordance with ERISA fiduciary standards. We believe proposed rule RIN 1210– AC03 should therefore also permit a plan fiduciary to demonstrate they have measured a client's ESG preferences in an economically grounded and robust manner.

Further Explanation
By way of analogy, plan sponsors include multiple investing options at varying *risk* levels, recognizing that different investors have differing risk preferences It does so to accommodate participants who prefer not to risk larger losses – those for whom the volatility associated with higher expected return/higher risk fund options creates too great a feeling of discomfort. In economic terms, that feeling of discomfort represents a reduction in a participant's "utility" at the prospect of a large drop in the value of their investments, which more than offsets any increase in utility that participant feels from expected higher returns. In other words, the pain of the potential loss is greater than the joy of the potential gain.

Likewise, participants' ESG preferences can be measured in economic terms similar to risk preferences. This logic rests on both economic literature and practical observation that each participant has a highly individualized set of ESG preferences, which underpin a highly individualized utility curve over ESG investing options – much as individual plan participants have individualized risk preferences.

The recent 10 years of economic research supports this view of ESG preferences (see below). Moreover, recent advances in decision science enable precise measurement and modeling of the *utility* that *individual investors* derive from varying levels of ESG performance.

The economic research concerns the domain of "social" or "distributional" preferences, in which we understand how individuals make tradeoffs between their own wellbeing and the wellbeing of others (in the case of ESG investing, "others" refers to society at-large). We have learned from the research that individuals have highly varied social preferences across many domains (personal, professional, political, investing, etc.) Moreover, we know that these preferences govern the significant life choices that individuals make, from career choices to voting decisions.

At the same time, advances in decision science have led to quick, precise and accurate methods for measuring investor preferences,** among them an investor's social preferences in an ESG context. These "revealed preference" methods are grounded in standard and behavioral economic theory, and use a series of gamified decision scenarios that investors complete on a digital device. Advanced mathematics lets us derive investor preferences from those decisions, and then enables utility modeling at an individual investor level – in other words, the science lets us find the utility-maximizing option for each investor among a given choice set of ESG and non-ESG funds.

We know that for many investors, their ESG preferences would lead them to choose ESG-themed funds in their investment portfolio over the non-ESG equivalent, because it would *maximize their utility*. They may derive utility from ESG-themed funds for a variety of reasons. Some see ESG as a risk-reducing measure, consistent with the argument to include ESG funds on their economic merit. Others derive satisfaction (i.e., utility) from knowing their investments are actively supporting companies whose core business is to try to solve ESG problems (e.g., Tesla). Still others gain utility by knowing the companies they are investing in are adhering to high standards of ESG practice more generally.

The natural next step is for the industry to begin adopting scientifically valid methods of measuring plan participants' ESG (and risk) preferences. These methods should be included when a participant's profile is assessed and documented. They should also be implemented as a recurring event in the participant's journey, to maintain alignment and optimize utility (i.e., wellbeing) with each participant's evolving preferences.

The good news - advances in decision science make ESG and risk preference assessment highly engaging for participants, and stand a good chance of pulling more employees into the retirement savings process.

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*We recognize and are supportive of the argument that ESG issues can represent material business risk or opportunities companies face, and should therefore be considered in the calculus affecting the core economic merits of an investment.

**These methods have also been effectively applied to risk preferences, concerning how individuals trade off risk and returns.

Academic research into social/distributional preferences:

1. Fisman, R. J., Kariv, S., & Markovits, D. (1007). Individual Preferences for Giving. American Economic Review, 97(5), 1858-1876. https://www.aeaweb.org/articles?id=10.1257/aer.97.5.1858

2. Fisman, R., Jakiela, P., Kariv, S., & Markovits, D. (2015). The distributional preferences of an elite. Science, 349(6254). https://doi.org/10.1126/science.aab0096

3. Fisman, R., Jakiela, P., & Kariv, S. (2017). How did distributional preferences change during the Great Recession? Journal of Public Economics, 128, 84-95. https://doi.org/10.1016/j.jpubeco.2015.06.001

4. Fisman, R., Jakiela, P., & Kariv, S. (2017). Distributional preferences and political behavior. Journal of Public Economics, 155, 1–10. https://doi.org/10.1016/j.jpubeco.2017.08.010

5. Li, J., Dow, W. H., & Kariv, S. (2017). Social preferences of future physicians. Proceedings of the National Academy of Sciences, 114(48), E10291–E10300. https://doi.org/10.1073/pnas.1705451114

Academic research into risk preferences, economic rationality in decisionmaking, and revealed preferences:

1. Ahn, D., Choi, S., Gale, D., & Kariv, S. (2014). Estimating ambiguity aversion in a portfolio choice experiment. Quantitative Economics, 5(2), 195–223. https://doi.org/10.3982/qe243

2. Choi, S., Fisman, R., Gale, D. M., & Kariv, S. (2007). Revealing Preferences Graphically: An Old Method Gets a New Tool Kit. American Economic Review, 97(2), 153–158. https://doi.org/10.1257/aer.97.2.153

3. Choi, S., Fisman, R., Gale, D., & Kariv, S. (2007a). Consistency and Heterogeneity of Individual Behavior under Uncertainty. American Economic Review, 97(5), 1921–1938. https://doi.org/10.1257/aer.97.5.1921

4. Choi, S., Kariv, S., Müller, W., & Silverman, D. (2014). Who Is (More) Rational? American Economic Review, 104(6), 1518–1550. https://doi.org/10.1257/aer.104.6.1518