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# Evaluating ESG funds: A fiduciary's guide to navigating some of the more complex circumstances

## Introduction

**A proposed regulation regarding the integration of environmental, social, and governance (ESG) factors into retirement plan investment decisions is expected to be finalized later this year. In the meantime, plan fiduciaries considering an ESG strategy will benefit from following a prudent, and well-documented fiduciary process to ensure investment decisions are made in the best interests of participants.**

What follows is a discussion of some of the more complex circumstances a fiduciary may face when considering ESG options, including replacing an existing non-ESG investment option with an ESG option and/or designating an ESG option as the plan's qualified default investment alternative (QDIA). In June 2021 we published a guide that discussed foundational considerations, and in November 2021 we published a commentary that focused on the most typical ESG scenarios facing plan sponsors.

## Background

On October 13, 2021, the U.S. Department of Labor (DOL) issued a proposed amendment to the "Investment Duties" regulation under Title I of ERISA titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." Key points of the proposed regulation include:

- Reinforcement of the DOL's view that a plan fiduciary may not sacrifice investment returns or assume greater investment risk as a means of promoting collateral goals.
- Plan fiduciaries may consider any factor material to the risk-return analysis, including ESG factors, when evaluating investments. *The DOL clarified that ESG factors are evaluated no differently than other material risk-return factors*.
- ESG factors may be used as the primary differentiator in an analysis of competing investment choices or may be used as collateral considerations provided that their inclusion otherwise complies with ERISA's duties of prudence and loyalty.
- An ESG-themed investment may be considered as a QDIA provided it is prudent and otherwise compliant with DOL regulations related to QDIAs. Where an ESG investment is selected as a QDIA, a plan fiduciary should consider prominently displaying any collateral benefits relied upon as part of the investment-selection process.

As part of the regulatory process, the DOL solicited public comments on the proposed regulation. Vanguard responded with general support of the proposal.

## Vanguard's position

Vanguard believes that when more than one investment alternative equally serves the financial interests of plan participants, the fiduciary may consider other factors subject to certain disclosure obligations. We also believe the DOL's proposal would encourage fiduciaries to offer plan participants a broad range of investment options, including appropriate ESG alternatives.

Vanguard clients are already increasingly adopting ESG options in their fund lineups. As of June 2022, 19% of Vanguard plans with 1,000 or more participants offered an ESG fund, up from 11% in 2017. As a result, 32% of participants currently have access to an ESG fund.

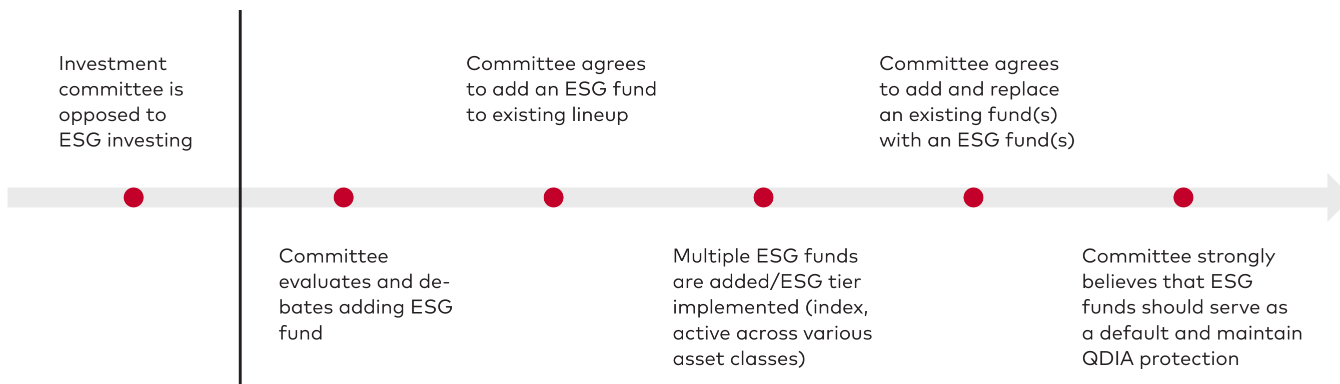
## Considerations regarding ESG investments

There is a range of decisions and strategies for plan sponsors to consider regarding ESG investments and their retirement plans. Generally, the considerations range from foundational to the most complicated.

The DOL guidance has reframed ESG related risks as financial risks to organizations and investments in those organizations rather than merely considering them as distinctly environmental/social issues. The mitigation of these risks is a critical part of an investment strategy, and it is important to evaluate and understand these risks in all products within a retirement plan.

Reframing the discussion from "ESG products" to "ESG considerations" of all investment products can help plan sponsors integrate their best thinking throughout the lineup, rather than creating separate processes for different types of investment vehicles.

**Spectrum of investment committee ESG considerations based on philosophical alignment and fiduciary complexity**



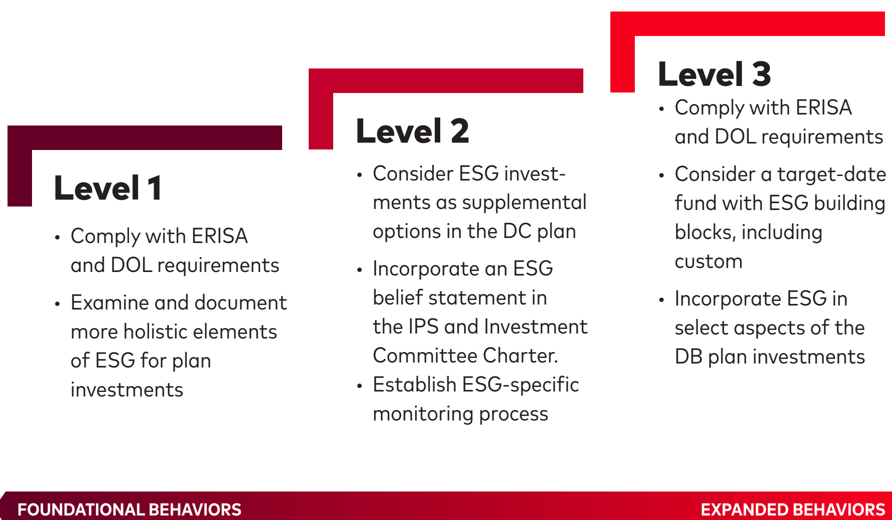
### A framework for evaluating ESG options

Having a robust, repeatable, consistent process for evaluating investment products across the plan's investment lineup is a best practice for plan fiduciaries and an expectation laid out by ERISA. Including ESG considerations within that process provides a more holistic framework to evaluate ESG-related risks, processes, investment stewardship, etc., across all investment options in a similar fashion.

Regardless of intent to adopt ESG-themed investment strategies, plan fiduciaries should be discussing ESG-related factors within the ESG behaviors framework.

To satisfy your fiduciary responsibility, evaluation of ESG products should not be a distinctly separate act from evaluating non-ESG products; the universe of options should be considered through a consistent, repeatable investment evaluation process that has been enhanced by including ESG-related risk factors. After following the proper process and evaluation, a fiduciary may consider replacing a non-ESG investment option in their lineup with an ESG-based option.

### ESG behaviors framework for plan fiduciaries




#### Considerations

- Corporate philosophy
- Conviction that ESG is a financial factor
- Investment choice and cost
- Level of fiduciary comfort with ERISA regulatory landscape
- Participant interest and communications
- Access to data

## ESG-based target-date funds

Additionally, the consideration of an ESG-based target-date fund as a plan's QDIA is certainly one of the most expansive, holistic approaches to ESG integration within a plan.

Since historically target-date funds have overwhelmingly been the choice of investment options used as QDIAs, a plan sponsor should already have a process for evaluating target-date vehicles. How might that process change with the introduction of ESG factors?

### Expanded target-date fund evaluation spectrum

| FOUNDATIONAL BEHAVIORS | EXPANDED BEHAVIORS |
| --- | --- |
| • Costs<br>• Glide path design<br>• Sub-asset allocation<br>• Governance<br>• Risk-adjusted returns<br>• Probability of meeting spending needs | • Costs<br>• Glide path design<br>• Sub-asset allocation<br>• Governance<br>• Risk-adjusted returns<br>• Probability of meeting spending needs<br>• Mitigation of ESG-related risks |

As a plan sponsor introduces ESG risk factors into their evaluation framework, *any* evaluation of a target-date fund should still consider these foundational factors. ESG risk factors may be added to the existing process as an enhancement but not as a replacement.

Once the decision has been made to adopt a target-date fund that accommodates ESG considerations as the plan's QDIA, it is important to document the process used to arrive at that option.

Further, it is advisable to disclose to plan participants any collateral benefits used by the plan fiduciaries to make that selection. It is important for plan participants to understand the rationale for including any new investment option in your lineup but especially so if you are changing the QDIA.

After completing the proper due diligence, following an established procedure, documenting the decision-making and providing disclosure to participants, a plan sponsor has basically fulfilled the same best practices for ESG options that Vanguard recommends for non-ESG options.

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ESG funds are subject to investment risk, which is the chance that the stocks or bonds screened by the index provider for ESG criteria might underperform the market as a whole or, in the aggregate, will trail returns of other funds screened for ESG criteria. The index provider's assessment of a company, based on the company's level of involvement in a particular industry or the index provider's own ESG criteria, may differ from that of other funds or of the advisor's or an investor's assessment of such company. As a result, the companies deemed eligible by the index provider may not reflect the beliefs and values of any particular investor and may not exhibit positive or favorable ESG characteristics. The evaluation of companies for ESG screening or integration is dependent on the timely and accurate reporting of ESG data by the companies. Successful application of the screens will depend on the index provider's proper identification and analysis of ESG data. The advisor may not be successful in assessing and identifying companies that have or will have a positive impact or support a given position. In some circumstances, companies could ultimately have a negative impact, or no impact.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in the target-date fund is not guaranteed at any time, including on or after the target date.

Diversification does not ensure a profit or protect against a loss. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

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