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Evaluating ESG funds in light of new guidance: A fiduciary's guide

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." There will be a 60-day public comment period that will enable interested parties to provide feedback to the DOL.

Among the key points of the proposed amendment:

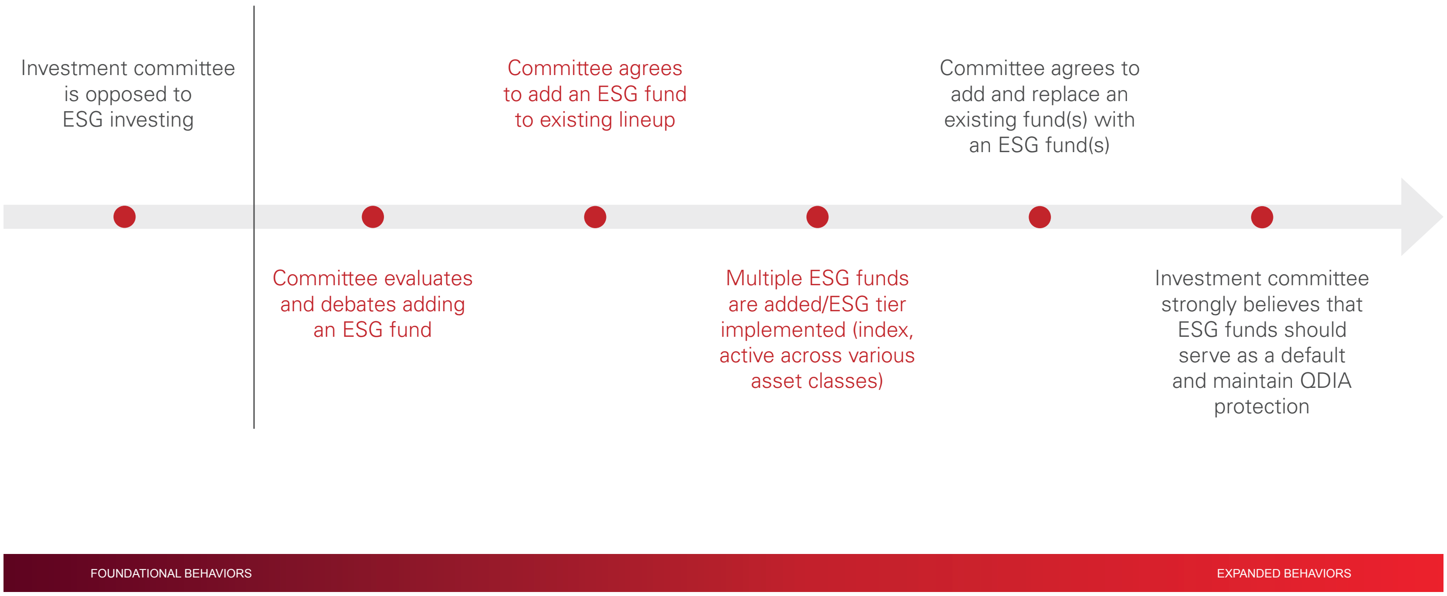
- It reinforces the DOL's view that a plan fiduciary may not sacrifice investment returns or assume greater investment risk as a means of promoting collateral goals.
- Plan fiduciaries may consider any factor material to the risk-return analysis, including environmental, social, and governance (ESG) factors and climate change, when evaluating investments. ESG factors are evaluated no differently than other material risk-return factors.
- ESG factors may be used as the primary 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 qualified default investment alternative (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 process.

The new guidance is expected to encourage even more consideration of ESG investments by plan fiduciaries. Vanguard clients are increasingly adopting ESG options in their fund lineups.

As of September 2021, 16% of Vanguard plans with 1,000 or more participants offered an ESG fund, up from 11% in 2017. Nearly 3 in 10 participants currently have access to an ESG fund.

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 basic or foundational to the most complicated. In June 2021, we published a guide that discussed foundational considerations. **This commentary focuses on the most typical ESG scenarios facing plan sponsors.** (Our third and final commentary will address the most complex approaches.)

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



A key question is whether the plan sponsor is seriously considering the addition of ESG fund(s) to their lineup? If the sponsor is ready to adopt ESG, the most typical approach involves adding an option(s) to an existing lineup rather than replacing an existing non-ESG option with an ESG option. (For purposes of this commentary, it is assumed that the ESG option will not be designated as the plan's QDIA).

Plan sponsor actions	Considerations
Understand the various ESG approaches and terminology.	Definitions and approaches to ESG vary widely; there is no universal ESG strategy. Types of ESG investing:* • **Portfolio screen.** Two iterations of screening: exclusionary, which omits certain sectors, countries, or securities based on ESG-related criteria; and inclusionary, which proactively includes certain sectors or companies based on higher ESG ratings relative to industry peers. • **ESG integration.** Systematic inclusion of financially material ESG information in the investment analysis process. • **Active ownership.** Asset managers use a variety of approaches to positively affect corporate behavior on ESG-related issues. • **Impact investing.** Target investments with the dual objective of generating some degree of positive ESG-related impact in addition to some level of financial return.
Determine if index and/or active ESG funds should be added.	• For index funds, an understanding of the methodology; if it's exclusionary, which sectors/industries are excluded? Are there any qualitative factors included? If it's inclusionary, whose ESG rating are you using? Why? • For active funds, does the committee have the comfort and ability to evaluate active managers and establish a process of ongoing monitoring and evaluation of qualitative, quantitative, and ESG-related factors?
Consider if the fund(s) align with participant demands or desires.	• How do you determine what your participants are looking for? • Without that knowledge, is the direction you want to go influenced?
Decide how many options they want to add to their existing lineup.	• Are you looking to add a few asset class exposures or for the ability to create a full ESG portfolio?
Consider the potential asset allocation implications with the addition of any ESG fund.	• Do you want to target a specific asset class only? • Do you want your participants to be able to have building blocks?

*Vanguard does not currently employ all of these methods.

Implement a process for evaluating performance and ESG-related factors.	• How do you update your current investment monitoring and evaluation process to account for the new ESG-related products? • What considerations do you add to your IPS to reflect the new ESG fund(s)? • Do you utilize new resources to evaluate ESG factors?

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.

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BBBBQKGL 102021