Cammack Retirement Investment Research: 
Socially Responsible Investing
Antony Khalilov, CFA
Investment Analyst, Cammack Retirement Group

INTRODUCTION
On October 26, 2015, the Department of Labor (DOL) issued new guidance on the suitability of SRI investments within pension and retirement plans. The new rule, Interpretive Bulletin (IB) 2015-01, presents a departure from previous, more stringent guidance issued by the DOL. The new guidance acknowledges that environmental, social, and governance (ESG) factors may have a direct relationship to the economic and financial value of an investment. Moreover, ESG factors are now viewed as more than just tiebreakers, and are considered to be proper components of a fiduciary’s analysis of the economic and financial merits of competing investment choices. This is a milestone in the DOL’s interpretation of the role of ESG consideration in the investment process, and will surely drive further consideration of SRI funds in retirement plans.

While socially responsible investing (SRI) has been around for decades, interest in responsible investing has been especially high in recent years. Even prior to the release of the new rule, demand for SRI funds has been on the rise due to the impact of divestment campaigns. This paper will examine the impact of the new DOL rule, as well as the factors shaping the dialogue around SRI investments and their suitability in retirement plans.

BACKGROUND ON SRI FUNDS
The roots of modern socially responsible investing lie in the early days of the 20th century, when an “ecclesiastical group in Boston established the Pioneer Fund.”

Until the late 1960’s, SRI focused on screening to avoid investment in “sin industries” such as alcohol, tobacco and gambling. Since that time, SRI has taken on multiple forms. The three main categories are:

- **Socially Responsible Investing (SRI)** – a process that uses ethical guidelines to avoid investing in certain companies, referred to as negative screening. A negative screen allows for inclusion of companies that refrain from engaging in undesirable practices.

- **Environmental, Social and Governance investing (ESG)** – a positive screening process for companies that employ environmental, social and governance policies which ultimately produce positive societal externalities. A positive screen may result in the inclusion of companies that are leaders in their industries with respect to SRI criteria, on a relative basis.

- **Impact Investing** – a system of investing in companies or projects that actively pursue social and environmental change, alongside a financial return. In other words, the mission of the company or the project is to provide a social benefit.

It is important to note that the terms do not have a singular meaning and the terminology continues to change. For our purposes, the term SRI will be used to describe any investment selected for its social, environmental or corporate governance criteria.

**THE DOL RULING AND ITS IMPACT FOR PLAN SPONSORS**

In 2008, the DOL released Interpretive Bulletin 94-01, which set forth the views of the Department of Labor concerning the legal standards imposed on plan fiduciaries when considering SRI investments. ERISA, which is the most significant piece of federal legislation governing retirement plans, establishes a clear rule that plan fiduciaries must always act in the best (economic) interest of plan participants, and may not select investments on the basis of any factor outside the economic interest of the plan except in “very limited circumstances”.

According to the old DOL rule, these “very limited circumstances” include situations in which two or more investment alternatives are of equal economic value. Only, in such cases, is the plan fiduciary allowed to consider social and environmental factors in the investment decision-making process. This standard has been commonly referred to the “all things equal test”. In other words, the old rule states that SRI considerations can be taken into account only as “tiebreakers,” when investments are otherwise equal with respect to their economic and financial characteristics.

In the note accompanying the release of the new rule, the DOL acknowledged that “in the seven years since its publication, IB 2008-01 (the old rule) has unduly discouraged fiduciaries from considering SRI factors.” An important purpose of the new rule is to clarify that plan fiduciaries should appropriately consider factors that potentially influence risk and return, including environmental, social, and governance issues which may have a direct relationship to the economic value of the plan’s investment. In these instances, SRI issues are not merely collateral considerations or tie-breakers, but rather proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.

In addition, the DOL does not construe consideration of SRI criteria as requiring additional documentation or evaluation beyond that required by general fiduciary standards which dictate that plan fiduciaries maintain records sufficient to demonstrate compliance with ERISA’s fiduciary provisions. As with any other investments, the appropriate level of documentation would depend on the facts and circumstances.

Another important statement from the new rule is that the fiduciary standards which apply to SRIs “are no different than the standards applicable to plan investments generally”. Therefore, if an SRI investment is selected with proper care and diligence, the fiduciary is not in violation of ERISA rules.

**SRI AND DIVESTMENT CAMPAIGNS**

The new DOL rule raised the discussion regarding SRI criteria at a time when the dialogue about fossil-fuel divestment was at fever pitch and energy markets were in turmoil. Divestment, as the name implies, refers to the practice of eliminating assets held in a particular industry or business, usually due to social, moral or political motivations. The notable modern divestment campaigns took hold as a grassroots effort at many of the nation’s institutions of higher education. Among the earliest of such movements was the divestment campaign against Apartheid in South Africa. That movement spanned two decades and culminated in many universities and religious institutions
fully or partially divesting from South Africa. However, it was not only universities and religious institutions that took action; General Motors and IBM withdrew business operations from South Africa as well. The tobacco divestment movement was similar to the anti-Apartheid divestment campaign. Doctors and public health officials were the primary advocates for public policy reform around tobacco sales and consumption. The movement did result in a meaningful political debate and legislation on a local and federal level. More specifically, public pressure caused policy makers to increase taxes on tobacco sales and consumption, outlawed smoking in public places and created many other policies that have changed consumer behavior with regards to tobacco.

As was the case in previous divestment campaigns, the direct financial impact of divestment from fossil fuel companies, in all likelihood, will be limited. The true impact of the divestment movement will manifest in the public policy debate regarding carbon emissions and subsequent changes in business incentives and consumer behavior. Neither the tobacco divestment movement, nor the anti-Apartheid movement before it, has caused meaningful financial hardship for the targets of the movement’s campaigns. The reality is that selling shares of public companies simply transfers ownership of the stock to another party who may not care as much about environmental and social issues. Given that shareholders exert influence over corporations through their voting power, many would contend that divestment is counterproductive because it reduces control over company management.

Nevertheless, many fossil fuel divestment advocates are looking to the recent bankruptcy of Peabody Energy as justification for fossil fuel divestment. Peabody Energy was the largest privately-held coal company in the world and once boasted a multi-billion dollar market capitalization. The company entered bankruptcy due to shifting public policy towards cleaner sources of energy, slowing demand for coal from China, and a booming supply of abundant natural gas. Carbon divestment advocates are using Peabody as a case study to argue that the risks associated with investments in the fossil fuel industry may be greater than they seem. The argument is premised with the view that shifting public policy away from fossil fuels and towards cleaner sources of energy will create huge losses for energy companies that have collectively invested significant resources into energy and exploration projects. A meaningful shift away from current energy consumption patterns could theoretically diminish the value of fossil fuel assets held on corporate balance sheets, thus leading to diminished returns for investors. The upshot of this reasoning is that now, and perhaps more than ever, SRI’s advocates have a strong case study upon which to support the merits of a low-carbon or other SRI investment.

PERFORMANCE OF SRI FUNDS
The performance of SRI funds has been a topic of debate since their introduction into the marketplace decades ago. Critics of SRI funds have contended that companies that consider ESG criteria bear additional costs in operations, which negatively impacts profitability and shareholder returns. More recently, however, many academic and industry experts have completed studies demonstrating that SRI strategies do not underperform traditional funds. With increasing evidence indicating that SRI funds have the potential to outperform, consideration of ESG criteria may point to important business issues that are hard to determine via traditional financial analysis. Ultimately, SRI performance will vary based upon the skill and execution of the individual manager.
PLAN SPONSOR CONSIDERATIONS

The decision to invest in SRI funds is connected to personal values, in addition to economic considerations. Given the DOL’s revised perspective on SRI funds, plan sponsors have unprecedented scope and ability to respond to their participants’ desire to invest in SRI funds. In order to successfully implement an SRI fund into an investment array, the plan committee must first ascertain the organization’s and plan participants’ values in order to screen for funds that are aligned with those values. For example, an organization dedicated to environmental protection may have a strong desire to invest in funds that exclude companies involved in fossil fuel sale and/or production.

SRI funds can be included in the investment array as stand-alone investment options or as complements to traditional funds. At present, most SRI funds are either large-cap or all-cap equity (all-cap refers to funds that are allowed to invest in companies of any market capitalization) and there is a growing number of allocation and fixed income SRI funds being offered. SRI funds will become increasingly prevalent in retirement plans and personal investing, but the tenets of prudence and diversification should still apply.

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For more information on our services, please contact Mike Volo, Senior Partner, at 781.997.1426 or mvolo@cammackretirement.com.

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