chief investment officer

Regulation September 1, 2023

Law Firm Letter Backs DOL Rule on ERISA Fiduciaries Using Climate Factors

Fiduciaries may use climate funds, as long as financial returns receive equal or greater weight to collateral benefits, the Wagner Law Group wrote in an open letter.

By Paul Mulholland

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

can consider “climate-aligned” funds in investment menus. The letter was written on behalf of Impact Experience, a nonprofit and advocate for sustainable investing.

According to the letter, the legal considerations for climate-aligned funds essentially come down to how a fund considers climate-related factors in its risk-return analysis.

According to the ERISA attorneys, if the fund subordinates financial returns to collateral benefits, such as combatting climate change or lowering greenhouse gas emissions, then its inclusion in an investment menu is not permissible under ERISA: “In no event may a DC Plan fiduciary subordinate the financial interests of plan participants to other objectives.”

If the fund does not subordinate financial interests to collateral interests, however, then climate-related factors may be added, provided that their inclusion is otherwise consistent with the duties of loyalty and prudence to the plan.

“A DC Plan fiduciary is permitted to select a menu option for its collateral benefits, only if such selection is made from competing menu alternatives where the

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

serve the financial interests of plan participant," the letter stated.

The language "equally serve" mirrors the language found in the Department of Labor's final rule on environmental, social and governance as it relates to ERISA, finalized in November 2022.

The DOL's outlines the "tiebreaker" test, in which an ERISA fiduciary decides between two investments, one with a collateral benefit and one without. According to DOL guidance, the fund with the collateral benefit may be chosen if both would "equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns."

Though this rule is facing two legal challenges, it is the governing rule.

Different Types of Climate Funds

Wagner outlined three categories of climate-aligned funds: climate integration, climate focused and climate impact.

Climate integration funds make adjustments for climate risks and

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

climate-related metrics. These funds can be considered on their own merits because they do not subordinate financial returns to collateral benefits, since they integrate climate risk as a financial return criterion.

Climate-focused funds use climate risks as a “significant factor” in selection. They may also feature positive or negative screens that include or exclude securities which meet or fail to meet particular climate-related thresholds. Similar to integration funds, focused funds can be considered on their merits as long as “the fund is not applying an investment screen in the pursuit of collateral or other non-investment benefits to the detriment of fund investors.”

When it comes to focused funds, the consideration of alternatives is key. Wagner recommended that a fiduciary “investigate competing menu alternatives that have conventional investment strategies and that are otherwise similar to the Climate Focused Fund.”

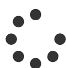
Wagner noted that ERISA does not, per se, forbid screens, and likens focused funds to specialty funds, or funds that focus on a specific sector and are often found in investment menus: “Specialty Funds are

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

the specialty fund's investment strategy. Analogously, it should be permissible to include prudently selected Climate Focused Funds in DC Plan menus."

Lastly, Wagner considered impact funds. As a best practice, Wagner recommends not adding impact funds at all to an investment menu, because they subordinate financial returns to climate goals and are willing to lower returns to that end if necessary: "As a suggested 'best' practice, we would recommend that Firms in their capacity as DC Plan fiduciaries exclude Climate Impact Funds."

Tags: ERISA, ESG



MOST POPULAR

Pension Plan That Had Been Insolvent Since 2009 Rescued by PBGC

Cash Gets a Bigger Role for Institutions, NextGen Honorees Say

SEC Adopts Private Fund Adviser Rules Aimed at Increasing Transparency

Virginia Retirement System Returns 6.1% in Fiscal 2023

Law Firm Letter Backs DOL Rule on ERISA Fiduciaries Using Climate Factors

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

Asset Allocation September 1, 2023

How Institutional Investors Are Thinking About Alts

CIO's NextGen honorees share their thoughts on a range of alternatives, from venture capital and private equity to private credit and infrastructure.

By Amy Resnick

Art by Jam Dong

Institutional asset owners have long allocated to the broad class of investments beyond stocks and bonds, known as alternatives. The different categories of alts, from private equity to infrastructure, to commodities and private credit, are sought as sources of

By using this site you agree to our network wide Privacy Policy.

OK, GOT IT

In 2023, the CIO NextGen honorees pointed to different benefits and risks across a variety of alts, and as can be expected, shared a diversity of opinions in response to questions we posed. Institutional investors, including pension funds, endowments and foundations, have been in private equity for decades, with the average allocation, across all types of asset owners, now nearing 25%.

Brent Mattis Jr., a principal in the Cleveland Clinic Investment Office, cited the wisdom of the late investing pioneer David Swenson, who ran Yale's endowment for decades, for leading the way on alts, particularly private equity. Swenson's wisdom was "that investors could earn excess returns by committing capital to niches where capital is scarce," Mattis wrote. However, Mattis cautioned that "the secular flow of capital from public to private markets is an excellent example of a 'good idea taken too far.'"

Wagner Dada, managing director in the systematic strategies group for capital markets and factor investing at the Canada Pension Plan Investment Board, noted alternatives—namely private equity, private credit and real assets—are attractive for most institutional investors "given their diversification and return

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

compensated risk premia and stable cash flows. … Real assets can offer institutional investors a way to harvest illiquidity risk premia. In the post-COVID years, we have seen inflation protection become a key consideration … spurring an interest in inflation protection alternatives like inflation linkers and commodities.”

Charlotte Zhang, investment director at the Inatai Foundation, called private equity the most important alternative asset class, citing the significance of PE offering allocators the opportunity “to capitalize on asymmetric information that informs sourcing, due-diligence and value-creation initiatives, having the benefit of long investment time horizons that enable strategic decisionmaking and strong corporate governance to implement operational changes that grow the value of a business.”

Carrie Green, director of equities for the Tennessee Department of Treasury, cited the importance of the venture capital segment of PE to the overall institutional investing ecosystem.

“Innovation is where all economic growth begins,” Green wrote. “So I believe institutional portfolios need a reasonable allocation to venture capital.

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

Lin Maung, senior portfolio manager at the State of Wisconsin Investment Board, pointed to advantages of PE as compared with public equities. “I firmly believe that alpha in private equity comes from fundamental advantages in how a company is governed and the skills and hard work of the managers we back. The combination of governance and manager skill are not easily replicable in the public market and constitutes a repeatable framework that can contribute strong returns to any program that chooses to commit to private equity.”

But Zhang also acknowledged some growing challenges.

“As more capital has flooded into this asset class, gaps of market inefficiency are closed more quickly, which erodes the go-forward expected returns,” Zhang wrote. “Investors should be mindful of selecting for strategies that adequately compensate them for taking on illiquidity risk, especially as entry valuations in private markets have remained relatively sticky compared to drawdowns in public markets.”

Toshie Kabuto, deputy chief of asset allocation at the International Monetary Fund’s investment office, also cautioned that institutions have to be aware of the

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

to add them, and it is hard to adjust the allocation or provide the right levels of allocation when you want them."

Beyond PE, the NextGens cited the newer, evolving alts class—private credit—as offering both opportunities and certain unique risks.

SWIB's Maung, who early in his tenure led an initiative to position SWIB's current return portfolio (or private credit) higher up the capital structure, cited "the user-friendly characteristics of direct lending relative to public leveraged finance" as offering allocators access to a market that was "going to widen to large-scale borrowers who historically would have tapped the public market. In addition, we viewed the strategy as 'all weather,' given the seniority, floating-[rate] nature and prevalence of lender protections."

He added, "direct lending has remained open for business through a volatile environment, large borrowers are increasingly choosing to finance privately in lieu of the syndicated market, and yields are in the low teens for senior credit, with lower leverage and continued prevalence of lender protections."

But as private credit and direct lending

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

Brian Clark, investment director at the Harry and Jeanette Weinberg Foundation, said he worries about some of the "very rosy growth and profitability projections" made for private loans before interest rates rose, but the same dynamic "should provide a large opportunity set for sophisticated credit investors who can navigate complex loan documents and is an area I continue to watch closely."

About the risks, Clark wrote: "Most of these companies never expected to see interest rates as high as they are today. With these loans typically being floating rate, companies' debt service costs have risen significantly, which will likely lead to many stressed and distressed situations. Many of these loans are covenant lite [which] can lead to creditor-on-creditor violence in which some investors get primed out of their senior positions and into more junior positions … in the capital structure. I believe this dynamic will take years to work its way out of the system and lead to significant capital impairment."

Michael Cimmino, a portfolio manager of hedge funds at GE Investment Management, was one of several NextGens who cited the importance of certain hedge fund strategies for limiting

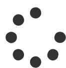
By using this site you agree to our network wide Privacy Policy. OK, GOT IT

credit and certain systematic long/short strategies."

But he said the bright light for alts in 2023 is infrastructure that enables investors to further capture "long-term secular trends occurring within the global economy while also diversifying away from traditional buyout and private debt strategies."

Among alts, Cimmino said, "Investors should continue to benefit from its defensive characteristics due to stable demand for the underlying asset and the long-term nature of contracts that include protections from inflation."

Tags: Alternatives, Asset Allocation, direct lending, Hedge Funds, Infrastructure, Private Credit, Private Equity, Special Coverage: NextGens



MOST POPULAR

Pension Plan That Had Been Insolvent Since 2009 Rescued by PBGC

Cash Gets a Bigger Role for Institutions, NextGen Honorees Say

SEC Adopts Private Fund Adviser Rules Aimed at Increasing Transparency

Virginia Retirement System Returns 6.1% in Fiscal 2023

By using this site you agree to our network wide Privacy Policy. OK, GOT IT

CHIEF INVESTMENT OFFICER

All News

Surveys

All Lists

Events

Multimedia

Thought Leadership

CIO Alert Archive

ABOUT CIO

About Us

Contact Us

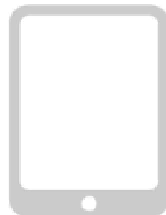
Advertise

Privacy Policy

ADVERTISE WITH CHIEF INVESTMENT OFFICER

GET ACCESS TO CHIEF INVESTMENT OFFICER EVERYWHERE

CHIEF INVESTMENT OFFICER IS OPTIMIZED FOR



MEDIA

CIO /PLANADVISER /PLANSPONSOR

702 King Farm Boulevard, Suite 400, Rockville, MD 20850 / +1 212-944-4455 / issgovernance.com

Copyright ©2023 Asset International, Inc. All Rights Reserved. No Reproduction Without Prior Authorizations.

By using this site you agree to our network wide Privacy Policy.

OK, GOT IT