Bloomberg Law®

How ESG Factors Should Be Bundled Inside Your 401(k) Funds

Since the Department of Labor released its environmental, social, and governance guidance in November, investors have been asking when they will see conscientious choices in their 401(k)s.

The answer is maybe soon or maybe never, but that doesn't mean ESG isn't already there doing what it's supposed to do.

The rule removed restrictions on retirement plan fiduciaries' incorporation of ESG factors—such as climate change mitigation and fossil fuel use—into plan investments.

ESG Factors

In broad strokes, ESG consists of criteria used to measure the negative effects, or costs to others, of a company's behavior. Examples of such criteria include things like climate change impact, employee working conditions, and board independence and executive pay.

Initially, the purpose of ESG data was to help investors assess a company's material risk associated with unsustainable practices. However, over the past 20 years, the E, S, and G data categories have been strung together to create ESG-themed investment products marketed toward socially responsible, ethically minded investors.

Thus, instead of serving as data points intended to assess a company's risk, ESG has instead become the investment product served to consumers. ESG-themed funds are now mainstream offerings on the retail investment market catering to consumer tastes.

Retirement Plans

This distinction between ESG factors that serve as informative data versus ESG the product being served to consumers is crucial to understanding the controversy around ESG in the pension and 401(k) world.

Pension and 401(k) plans are subject to federal pension law (ERISA), which tasks fiduciaries to make prudent investment decisions solely with plan participants' financial best interests in mind.

Prior guidance issued by the Trump administration expressed overt skepticism of ESG investing, stating that "the relevant question is not whether a factor under consideration is 'ESG,' but whether it is a pecuniary factor relevant to an evaluation of the investment or investment course of action under consideration."

The DOL's November guidance from the Biden administration revoked the Trump guidance in order to remove any "chilling effect." The DOL now affirmatively states that a plan fiduciary can consider ESG factors in selecting an investment when such factors are material to the risk-return analysis.

Moreover, the agency goes even further to suggest that a fiduciary may take participant preferences into account when making prudent investment decisions.

It's likely that 401(k) participants and the fund industry in general will see the new DOL rule as a positive, because it opens the door to—you guessed it—ESG-themed choices and products within the 401(k) investment lineup.

Approach to Bundling

Yet, consider the potential pitfalls of approaching ESG in this way. To appeal to participants' wide array of preferences, it will be tempting to add a familiar product that claims to be a "multi-asset" ESG fund that invests in "best in class" across all ESG categories and outperforms its "peer" group.

What is this thing (a balanced fund?) and what is its peer group—other balanced funds or only ESG-themed ones? That's extremely important to understand when assessing performance.

Furthermore, the implication of "best in class" suggests that the fund's stocks have high marks in each ESG category, but does each category necessarily generate the same level of sustainability risk?

This raises a very fundamental question: Should ESG factors necessarily be bundled together? It might be more prudent to examine such factors independently to better understand the corresponding sustainability risk.

If climate change impact is the most significant risk factor of our time, then plan fiduciaries ought to be justified in offering focused 401(k) choices like clean energy funds, rather than generic ESG multi-asset funds.

Moreover, looking at ESG criteria independently may actually encourage plan fiduciaries to do a better job of examining ESG attributes across a 401(k) plan's entire fund lineup, not just the one fund with the ESG label.

This may be more in harmony with the notion that ESG is about managing systemic risk rather than simply being a consumer choice. ESG should serve the plan rather than serve the consumer.

So, if you don't yet see an ESG fund in your 401(k) in the near future, don't assume it isn't there. In fact, it may well be everywhere in your plan. You just don't necessarily see it because it doesn't have a label.

Author Information

Michael Voves is chair of international law firm Dorsey & Whitney's benefit and compensation group and head of the firm's executive compensation practice group.