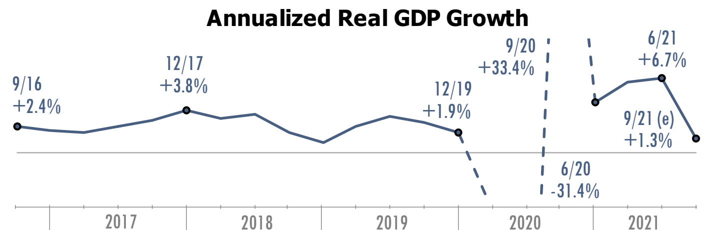
Bellwether
CONSULTING

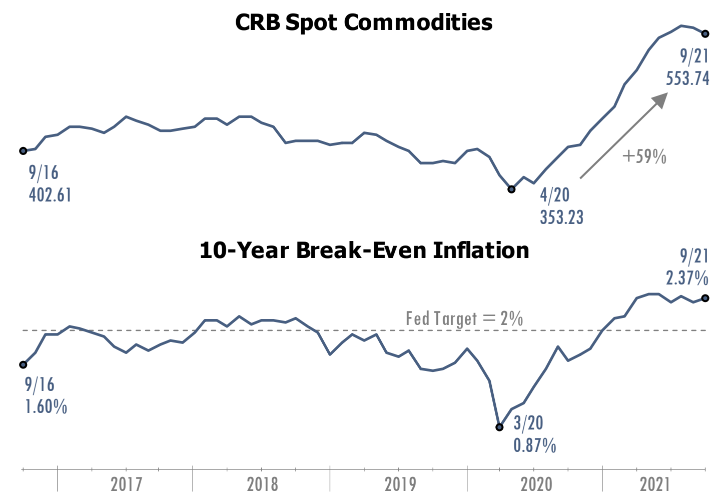
Your Quarterly Update on the Financial Markets
September 30, 2021

MARKET Recap

The US Economy: "Talent in Short Supply"

The pace of real economic growth flattened in Q2 at a still-elevated 6.7%, reflecting continued recovery from COVID. Early indicators suggest Q3 growth will begin to roughly resemble pre-COVID levels, with the Atlanta Fed's GDPNow indicator hovering just over 1%. Personal consumption expenditures rose in Q2, and in Q3 through August. Inflation was a significant factor, with the PCE price index increasing 6.5% for Q2 (6.1% ex food and energy).





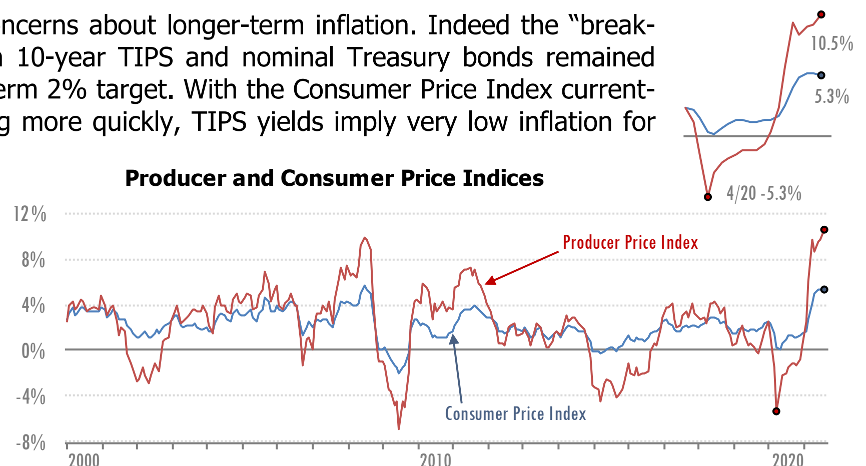
Not enough time has elapsed since the expiration of enhanced federal unemployment benefits to draw conclusions, but incremental data offers little evidence of improvement in the situation for employers. Workforce participation remains depressed at 61.7% (see last quarter's Market Recap for related discussion). Disposable personal income reported through the Bureau of Economic Analysis increased $18.9 billion (0.1%) in August driven by rising private sector wages, while real DPI decreased 0.3%. People are making more money but spending it at a faster rate to consume less goods and services.

Supply chain issues continued to impact manufacturers and a substantial portion of the services sector. Timothy Fiore, Chair of the Institute for Supply Management Manufacturing Business Survey Committee, noted the challenges evidenced in the September ISM Report on Business. He stated that, "All segments of the manufacturing economy are impacted by record-long raw material lead times, continued shortages of critical materials, rising commodity prices and difficulties transporting products." He further notes the impact of worker absenteeism and difficulties in filling open positions. Order backlogs expanded for a 15th straight month.

Press coverage tends to characterize the entire inflation phenomenon as entirely "transitory" or not. The key question is not whether, but how much, is transitory. In our view, upward pressure on wages reflects longer-term trends and shorter-term political forces which are likely to persist. Supply chain issues are temporary, although it should be noted that talent shortages are likely dragging out those problems over a longer timeframe.

Thus far, bond investors have not bought into concerns about longer-term inflation. Indeed the "break-even" inflation rate, which equates the yields on 10-year TIPS and nominal Treasury bonds remained stable for the quarter, just above the Fed's long-term 2% target. With the Consumer Price Index currently running at 5.3% and producer prices increasing more quickly, TIPS yields imply very low inflation for the back end of the next 5 years.

It is interesting that break-even inflation has paralleled the increase of commodity prices so closely throughout the COVID crisis. One wonders how much programmatic trading drives the relationship, as commodity price data arrives more quickly than labor market data. Shortages in oil and industrial commodities have driven past inflationary episodes, but we think talent is the "commodity" in short supply this time.



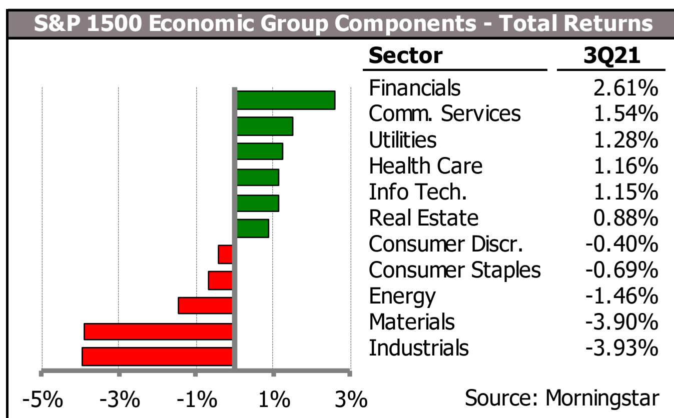
The US Stock Market

After late-September declines, the US stock market snapped a five-quarter streak of strong performance. Volatility was fueled by a host of issues, including US debt limit drama, persistent supply-chain disruptions, and labor shortages. Inflation proving to be less transitory than expected and fear of fallout from Chinese property developer Evergrande's debt crisis also worried investors. Many market indices closed the period in the red. The Nasdaq and Dow posted their first negative quarters since Q1 2020. The S&P 500 managed a Q3 return that was just modestly positive, despite 18 record closes in July and August.

US Stock Indices - Total Returns

Large-cap Stocks	**3Q21**	**Mid-cap Stocks**	**3Q21**
S&P 500	0.58%	S&P Midcap 400	-1.76%
Russell 1000	0.21%	Russell Midcap	-0.93%
Growth	1.16%	Growth	-0.76%
Value	-0.78%	Value	-1.01%
Broad Markets		**Small-cap Stocks**	
S&P 1500	0.35%	S&P Smallcap 600	-2.84%
Russell 3000	-0.10%	Russell 2000	-4.36%
Growth	0.69%	Growth	-5.65%
Value	-0.93%	Value	-2.98%

For a second consecutive quarter, growth outperformed value everywhere except small cap and returns increased as you went up the capitalization spectrum. A preference for large caps often signals increasing concern over economic slowdown with investors seeking the relative safety of established companies over the growth potential of their smaller counterparts. In the last weeks of the quarter, a volatile market produced days when a rotation back to value appeared to be in the works as tech sold off and financials rose on the expectation of higher interest rates. Outperformance by small-cap value over small-cap growth was attributable largely to strong performance in retail and energy. Macy's, a top holding in Russell 2000 Value ETFs, posted a return of 20% for the quarter on a strong earnings report, a reinstated dividend, and the announcement of the acquisition of Toys R Us. Chesapeake Energy, another top holding, had a quarterly return of 19% driven by rising natural gas prices.

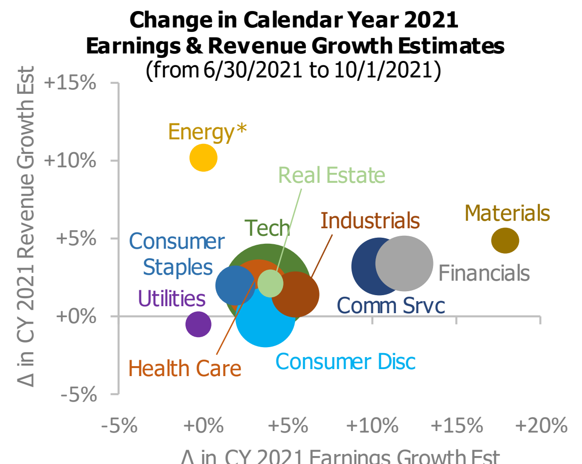


Sector	3Q21
Financials	2.61%
Comm. Services	1.54%
Utilities	1.28%
Health Care	1.16%
Info Tech.	1.15%
Real Estate	0.88%
Consumer Discr.	-0.40%
Consumer Staples	-0.69%
Energy	-1.46%
Materials	-3.90%
Industrials	-3.93%

After a rocky start in July, and despite the late-quarter volatility, the financials sector was the top performer. Banks tend to prosper in rising rate environments where their lending businesses can profit from borrowing at short-term rates while originating loans at longer-term rates. A redeployment of excess cash currently held by many banks should bolster earnings. Higher-rate environments are beneficial as well because they lead to stronger profit margins on cash holdings, money market funds, and other spread products.

Communication services, utilities and health care began posting stronger returns in August and rounded out the list of top-performing sectors in Q3. Like the large-cap play, investor preference for these defensive sector stocks is often an indication that the market is expecting an economic slowdown. Communication services and utilities are two of the top dividend-paying sectors, a safe haven frequently sought by investors during stressful market or economic periods.

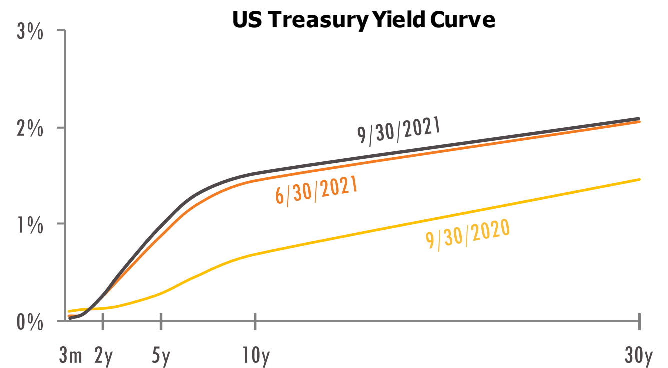
After three quarters of strong relative returns, the energy sector was the worst performer in July and August. The outlook for demand declined on outbreaks of the COVID-19 Delta variant and stockpiles of crude rose unexpectedly. Energy fared better in September, posting the only positive return among its sector peers. Lower oil and natural gas production in the wake of Hurricane Ida along with increased demand for natural gas driven by hotter August temperatures and spillover demand for oil from a global natural-gas production shortfall drove the month's returns. Ultimately, the sector ended Q3 as a relative underperformer, despite benefitting from September increases in crude prices as well as a surge in reflationary trades.



Earnings growth in Q3 for S&P 500 companies is forecast at 27.6% YoY, which would be the third highest growth rate for a quarter since 2010 [FactSet]. A double-digit earnings growth rate continues to be expected for 2021 as well. Analysts again increased earnings estimates for S&P 500 companies over the quarter with the energy and materials sectors showing the largest gains.

The US Bond Market

While bonds stirred up trouble overseas, the US rates space was most notable for how little changed quarter over quarter. A COVID-19 surge mid-July rattled investors, prompting dollars to flow upstream in credit quality and from equities into fixed income. The 10-year Treasury declined 26 basis points (bps) as high yield spreads widened 40 bps. These offsetting actions kept BB-rated bond yields stable. Credit spreads remained elevated for several weeks before drifting back to a 14-year trough set in June. The 10-year yield, which had hovered around 1.3% much of the quarter, briefly topped 1.5% after the Fed announced in late September their plans to start the tapering process "soon."



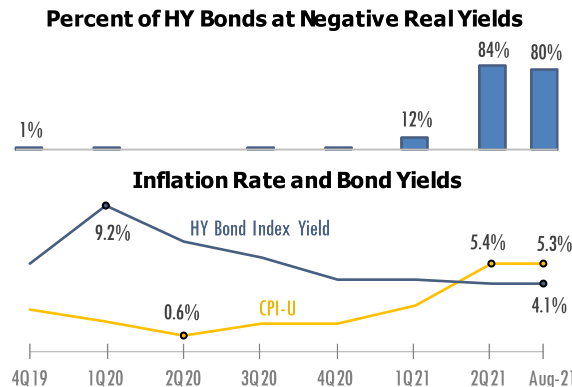
US Bond Index Returns	
Bloomberg Idx	**3Q21**
Aggregate	0.05%
Short Gov't	0.05%
Interm. Gov't	0.00%
Long Gov't	0.46%
TIPS	1.75%
Municipal	-0.27%
Interm. Credit	0.07%
Long Credit	-0.18%
High Yield	0.89%
(CS) Lev. Loan	1.13%
MBS	0.10%

Under Greenspan or Bernanke, "soon" would have been the limit of clarity and forward guidance bestowed by the Fed. However, Fed Chairpersons since have taken heed of the taper tantrum that rocketed rates and rocked markets in 2013. Powell has indicated tapering will likely start in November, run through the middle of next year, and precede any rate hikes.

Prior to the 2008 Global Financial Crisis, Fed assets weighed in at a svelte trillion dollars before gaining $3.5 trillion in six years. This time, the Fed grew its balance sheet $4.5 trillion in 18 months. Yet, tapering should take about as long as it did in 2014. While tapering removes some accommodation, easy monetary policy is not about to end abruptly. Powell asserts that rates will remain below the long-term trend through 2024. This is reassuring to markets in the short term, but heightens long-term inflation concerns.

Returns were muted, but mostly positive across the major US bond indices. US TIPS was the strongest performing sector, despite real yields holding steady. Inflation concerns have oscillated between sanguine and anxious this year. CPI data for March through June averaged monthly increases ranging from 0.6% to 0.9%. Higher inflation prints boost US TIPS returns. Less obvious is the effect on TIPS portfolios' reported yields.

As inflation numbers move around, bond managers are able to inflate the 30-day SEC yield on their funds. Asset managers must report the yield on their portfolios as specified by the SEC, but there exists some ambiguity in how to apply adjustments for inflation to the portfolio's yield. US TIPS funds are showing SEC yields as low as -2.3% and as high as 9.8%. Their 12-month yields are also widely dispersed, but more reasonably between 0.0% and 4.9%. While yield is a helpful predictor of fixed income returns, the realized dispersion in returns for these extremely similar portfolios is quite unlikely to be anywhere close to 5%, let alone 12%. The trailing 12-month return difference of the 95th and 5th percentiles is less than 75 bps.



Inflation also pushed high yield debt into novel territory. Many of the bonds in the Bloomberg HY Very Liquid index are trading at negative real yields. This indicates high yield investors subscribe to the transitory inflation narrative; however, it also raises the obvious question of whether the market is providing enough of a reward to warrant accepting the significant risks presented by high yield debt.

International Markets

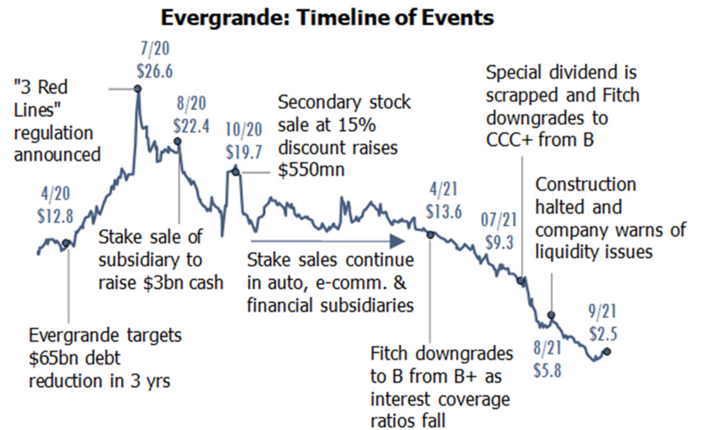
Growth cooled off globally in the third quarter and leading macro indicators surprised to the downside. Inflation remained stickier than expected, accelerating the timeline for monetary tightening laid out by many central banks. Compared to the strong first half of 2021, equity markets, most notably in emerging markets, experienced an uptick in volatility. China's sweeping regulatory tightening is expected to impact growth not just in China, but across many economies sensitive to China's economic growth.

Global bonds also sold off, following hawkish comments late in Q3 from the US Fed and the Bank of England. Unlike in Q1 when rates rose alongside growth expectations, the recent uptick is more characteristic of a "stagflationary" narrative.

Asia

China's economic rebound slowed in the second quarter. GDP grew by 7.9% from a year earlier, down from 18.3% in the first quarter. Data released in August warns that the economy may be slowing down further. Retail sales were weaker due to late July outbreaks of the Covid-19 Delta variant. Retail sales rose 2.5% in August from a year earlier, the slowest pace of growth in a year, down from July's 8.5% YoY growth. Services such as restaurants and tourism were hit particularly hard. As a result, CPI remained muted in August.

Property sectors were weaker due to tighter regulations which capped banks' exposures to real estate, both in loans to developers and mortgages. Land auctions were overhauled and a new "3 Red Lines" regulation restricted more indebted developers from taking on new debt. These changes led to problems for Evergrande Group, a developer with projects in over 200 cities. Evergrande owed the equivalent of around $88 billion in outstanding debt at the end of June, about 42% of which comes due in less than a year. Toward the end of the quarter, the company defaulted on $83.5 million in interest payments for its dollar-denominated bonds. Under the new regulations, cash became so short that the company started paying some suppliers with unfinished apartments.



Embedded across China's financial system and economy, Evergrande could cause a national financial crisis. In theory, its collapse would chase investors away from other developers, setting off a chain of defaults. It also may discourage consumers from buying property at a time when sales are already plummeting. Jobs created by Evergrande and its downstream suppliers would also be undermined. Signs of stress are appearing in bank loan books as more corporate loans to developers go sour. This is also expected to impact building companies and makers of construction equipment, furniture, and household appliances.

Beijing's pressure on the real-estate sector is being felt far beyond Evergrande. The total value of homes sold fell 19.7% in August YoY, the largest drop since April 2020. Construction starts fell 3.2% year to date through August, and shares of other property developers have already been hit.

Domestic consumption and the property market have, for a long time, been key drivers of growth, but weakness in these two sectors sent an official gauge of nonmanufacturing activity into contractionary territory for the first time since the country's pandemic recovery began more than a year ago. The non-manufacturing PMI declined in August. Factories have powered the country's post-pandemic recovery for more than a year. In Q3, they showed signs of losing steam, dragging the official manufacturing PMI down to its lowest level in 18 months.

Industrial output decelerated from July's 6.4% increase to a 5.3% YoY rise. It was the slowest growth rate in more than a year. Labor shortages across the country contributed to the slowdown as young people shunned factory jobs in favor of better paid service-industry jobs and more migrant workers stayed home. The country's decades-long one-child policy, formally abandoned in 2016, is also to blame. China's working-age population, people between 15 and 59, fell to 63% of the total population from 70% in 2010.

Those trends are leading to inflationary pressures as factory owners are forced to pay higher wages and provide better benefits. Already under pressure from rising prices for raw-materials and shipping, profit margins are eroding as well. Higher coal, steel, and other commodity costs drove the producer price index 9.5% higher in August from a year earlier, the highest increase in 13 years.

As factories struggle to find workers, white-collar job seekers outnumber white-collar job openings. July's urban unemployment rate declined to 5.1% from 5.7% a year earlier. The jobless rate among those aged 16-24 was close to an all-time high at 16.2%. Beijing's recent clampdown on the country's private tutoring industry may increase this further since the sector had been one of the biggest sources of jobs for college graduates.

Exports expanded at an accelerated pace, unaffected by a global resurgence of the coronavirus, port congestion, and supply bottlenecks. Export rose 25.6% in August from a year earlier, higher than the 19.3% increase in July. It was expected that exports would taper off as demand declined for protective gear and work-from-home electronic products, the

main goods driving an export-led recovery last year. However, other Chinese-made consumer goods, such as household appliances, furniture, and clothing, filled the gap. Overseas shipments of some high-tech products, such as semiconductors, continued to outpace other major export categories, although cellphone shipments weakened. Imports jumped 33.1% from a year earlier, accelerating from July's 28.1% growth and beating economists' projections.

Government scrutiny also extended to technology companies, which helped drive the quarter's stock market decline. The CSI 300 Index returned -6.85% in Q3. From its peak on February 21, the index has fallen 16.21%.

In Japan, consumer prices remained stable in August for the first time in 13 months, ending its longest deflationary streak since 2011. Prices, excluding fresh food, were unchanged from a year earlier. Rising costs for hotels, processed food and energy were largely responsible for the stability. However, continued weak inflation readings have hamstrung the BOJ, which is keeping its stimulus tools in place for the foreseeable future.

Foreign Stock & Bond Index Total Returns

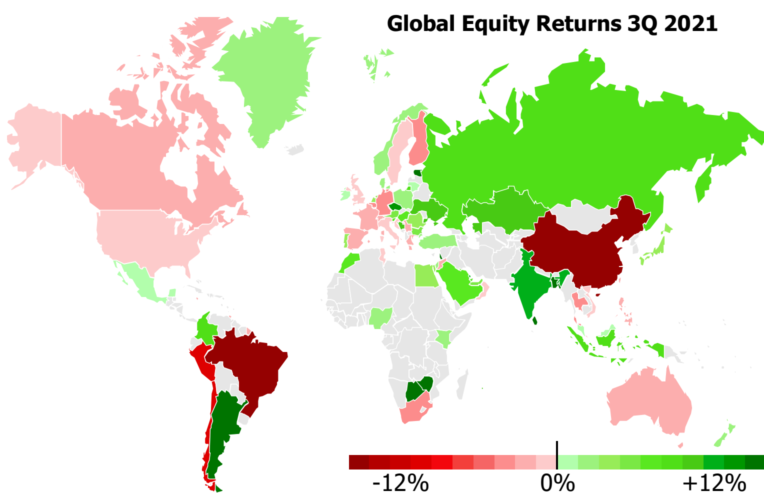
MSCI Broad	**3Q21**	**Bloomberg Global***	**3Q21**
MSCI ACWI ex-US	-2.99%	Global Aggregate	-0.88%
EAFE (Developed)	-0.45%	Pan-Euro	-2.57%
Emerging Markets	-8.09%	Asian-Pacific	-0.16%
		Eurodollar	0.72%
MSCI Regions		Euro-Yen	-1.79%
Europe	-1.55%	Other Currencies	-4.26%
Japan	4.56%	* Unhedged	
Pacific ex-Japan	-4.40%		
Latin America	-13.26%		

Europe

European equities underperformed other developed markets amid headwinds from supply-chain issues, rising energy prices and decelerating growth expectations. The impact of China's regulatory clampdown was felt particularly hard in the consumer discretionary sector, the quarter's largest underperformer. Luxury retailers, LVMH and Kering, generate over 40% of sales from China and were sensitive to the signs of a slowdown in the region.

Persistent supply-chain issues also weighed down earnings expectations for industrials, a driver of recent strength in Europe. Manufacturers have been hamstrung by rising input costs and shipping delays. In September, manufacturing growth, flash Manufacturing PMIs came in at 8-month lows for Germany and France. Services, too, appear to have passed the point of peak growth post-reopening.

Following a decade-high inflation print of 3% in August, European Central Bank President Christine Lagarde reiterated that there were "no signs that this increase in inflation is becoming broad-based" and that the ECB would not overreact to transitory supply shocks. Despite the continued dovish tone, yields across Europe reversed their downward trajectory and pushed higher from late August.



Standing in contrast to the ECB was the Bank of England's sharp shift in policy guidance in Q3. BoE Governor Bailey admitted to worries that long-term inflation expectations may rise in response to the transitory inflation surge, expected to average 4% for 2021. To combat this, Bailey stated that the central bank may be forced to raise rates even as growth slows. UK yields rose materially in response. The 10-year Gilt jumped 50 basis points from its lows in August to close the quarter above 1% for the first time since May 2019.

The pickup in yields, combined with higher energy prices, proved a tailwind for the value factor. Financials and energy, traditional value sectors, outperformed in this environment and may continue to see inflows given attractive dividend yields and relative valuations still well below the historical median.

Americas

The Bank of Canada believes the economy is on trajectory to stop its QE program, but it isn't quite there yet. BoC Governor Tiff Macklem indicated that policy interest rates would begin to rise once there is a need to reduce monetary stimulus. At that point, the bank would move to the reinvestment phase of QE, where the central bank will buy only enough bonds to replace those that are maturing (about $800mn a week), essentially maintaining stimulus.

While rising COVID-19 cases and supply chain disruptions continue to weigh on Canada's economic performance, many of the hardest-hit sectors rebounded during the summer. However, a rising fourth wave of cases and the continuation of

work from home has impacted commercial real estate. The national office vacancy rate rose to 15.7% during the quarter, the highest level since 1994.

Consumer prices in Brazil rose 0.9% in August, slightly below the 1.0% increase seen in July. Up from an annual reading of 9.0% as of July, the August inflation print was 9.7%, the highest rate since early 2016. In response to this and expected moves by developed central banks, Brazil increased its benchmark rate from 2% in Q1 to 5.25% currently. Many analysts expect the key rate to continue to move higher.

Mexico's economy lost steam in response to a resurgence of COVID-19 cases. Through August, a pullback in manufacturing and non-manufacturing PMIs occurred, as consumer confidence fell. By the end of the year, GDP growth is forecast to recover much of the 8.3% lost in 2020.

Focus On: Revising Regulations on ESG Funds – An Open Letter

Dear Secretary Walsh,

Congratulations on becoming the 29th US Secretary of Labor. We imagine you have been very busy in the last six months, as labor policies often change significantly when a new party takes the reigns. Odd, though, that one of the first issues you will deal with is revising Trump-era guidance on the use of Environmental, Social, and Governance (ESG) factors in managing retirement plan assets.

Prior to the last administration, ESG was not a particularly divisive issue, commanding a relatively small amount of time and attention from the Department of Labor (DOL). In our view, ESG should require little regulatory guidance; basic application of the first principles of ERISA should suffice. We argue that current law both permits ESG-focused investments, and places reasonable limits on their use.

First Principles: Loyalty and Exclusive Benefit

Rather than seeking to foresee, analyze, and regulate every possible form of investment, ERISA is based on a clear set of fiduciary principles. Foremost among them is the duty of loyalty, which requires fiduciaries to invest plan assets for the "exclusive purpose of providing benefits." The very specific latter requirement is there for a good reason – to preclude fiduciaries from justifying investments using indirect arguments.

It is irrelevant that an investment strategy might make the world a better place with cleaner air (even though participants happen to live in that world and breathe that air). It is also irrelevant that an ESG investment might enhance the employer's image and standing in the market (even though some participants' prospects for future financial success or job security might depend on that image and standing).

"... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."
[29 USC §1104(a)(1)]

Paying benefits is the key. Only benefits that are to be paid to participants by the plan matter. Any decision to invest in, or offer, an ESG-themed fund should follow from a reasoned expectation that the participants' future benefits will be increased or better secured by that fund.

Past attempts to offer regulatory guidance on ESG investing have focused on a very traditional interpretation of benefit enhancement. Under past guidance, the fiduciary must have a reasonable expectation that the investment will result in a portfolio with higher expected return and/or lower expected risk than would be expected without the investment fund.

Pension Plans – It's All About Risk and Return

That makes a great deal of sense for defined benefit pension plans, where the employer bears the investment risk and participation is mandatory. For these plans, improving risk-adjusted asset returns is the only way fiduciaries can enhance the plan's benefit payments (nearly always by better securing them, since participants do not share the upside).

It stands to reason that, for pension plans, adherence to ESG standards cannot be an investment objective in and of itself. It can only come into play to the extent fiduciaries believe stronger ESG standards will contribute to better risk-adjusted returns. Unfortunately for ESG advocates, that argument is a heavy lift. While many investors want to believe higher ESG scores "should" lead to better financial performance, there is little evidence that they do.

Further, the widely-accepted framework of modern portfolio theory argues that, at best, restricting managers to securities with high ESG scores should have no impact on risk-adjusted returns. Arguably, any constraint on security selection on active managers can be viewed as imposing a risk-adjusted return cost. After all, an unrestricted manager is free to pick

securities with high ESG scores, if the manager is convinced that they happen to offer the best prospects. An ESG-focused manager has fewer arrows in the quiver.

So, it is difficult to arrive at a pure investment rationale for ESG-focused investment funds in pension plans. That is not to say a loyal fiduciary might evaluate the strategy without regard to the ESG mandate and conclude it is the best available strategy – compared to all other strategies including non-ESG funds. But the odds of that happening are relatively low – there are many more non-ESG investment funds available, with lengthier track records.

This framework is the gist of past DOL guidance, and explains why usage of ESG-focused funds in corporate DB plans is relatively low – even prior to the overtly political anti-ESG rule promulgated by the last administration. In our view, there is little room for ESG funds in pension plans, nor should there be.

401(k) Plans – Investor Preference Also Impacts Benefits

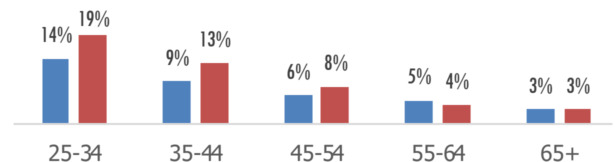
What about defined contribution plans? They clearly represent the future of corporate retirement, generating nearly all of the organic growth in assets. Unfortunately, past guidance on ESG in 401(k) plans has been vague and contradictory. We believe the same principles apply; however, the principles may legitimately lead to different conclusions.

A loyal fiduciary must still focus exclusively on the benefits to be paid by the plan. Those benefits may be enhanced (increased or better secured) by using investment strategies with superior expected risk-adjusted returns. That decision path leads to the same issues as discussed for pension plans, with the same limitations and weaknesses. However, there is another path for benefit enhancement for 401(k) plans. The benefits to be paid under the plan are a function of both the investment returns earned and the willingness of eligible employees to participate and defer their pay.

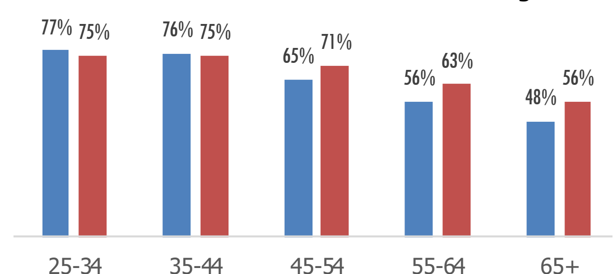
One of the most fundamental differences between 401(k) and other types of retirement plans is participant choice. Workers can direct their savings into their 401(k), or into other retirement or non-retirement investment accounts (which may be more expensive, less tax-efficient, and subject to claims of creditors). For that matter, they may choose not to save at all. Unlike pension plans, the 401(k) must compete with IRA's, brokerage accounts, and shiny new SUVs.

Without contributions, there can be no investment returns and no benefit payments. Further, the greater the contribution level, the greater the benefits will be under the plan with 100% certainty. It is entirely reasonable, and consistent with the duty of loyalty, to justify an investment fund based on a reasoned belief that employees will be more willing to participate in the plan, and more willing to increase their contributions, if a certain strategy is made available to them. In fact, the linkage to the exclusive benefit rule is clearer than a risk/return based argument, since contribution increases generate greater benefits with no risk at all.

Retail Investors Currently Employing ESG Strategies



Retail Investors Interested in ESG Strategies



2018 2020 Source: CFA Institute

Prudence and Benchmarking

From the perspective of loyalty, the path to offering ESG-oriented funds is much more straightforward for 401(k) plans. Of course, loyalty is not the only fiduciary duty. The duty of prudence demands that any investment decision be based on thorough and diligent research.

It also demands that investments be appropriately benchmarked and monitored for adverse developments, driving changes where appropriate. The investment industry has developed a wide array of indices that can serve as benchmarks, including ESG-optimized indices. How should an ESG-focused fund be benchmarked? It depends on how use of the investment is justified.

A sound benchmark is a passive alternative portfolio which would fulfil the same investment objective as the fund being evaluated. When an ESG-focused fund is offered based on an expectation of greater risk-adjusted returns, high ESG factor scores is not an investment objective. ESG factors are characteristics that describe the strategy; the objective is to obtain better risk-adjusted returns, regardless of how the better returns are obtained. In this case, the appropriate benchmark would be an index that represents the entire investable market available to that fund, including companies with high and low ESG scores. For example, a US largecap ESG fund might appropriately be benchmarked against the S&P 500, Russell 1000, or MSCI USA Index.

However, when an ESG-focused fund is offered in a 401(k) plan and justified by an expectation of higher participation and contributions, ESG factors are more than a characteristic. The investment objective is higher participation and contributions, and the appropriate benchmark would be an index which is optimized for higher ESG factor scores. Comparing the fund to a non-ESG index would be pointless, because that index could not fulfill the objective.

This is an important point which, in our view, the Department has consistently missed. Past guidance has suggested that all ESG funds should be benchmarked against non-ESG indices, regardless of how the fund is justified or used. Ironically, this has made it particularly difficult for fiduciaries to consider low-cost ESG index funds.

Where fiduciaries rely on a participation-based argument to offer an ESG-focused strategy, it is fair to ask whether the expectation of increased participation or contribution levels is reasonable. It is a decision under risk; a fiduciary may hold the opinion that participants want access to ESG investments, yet in hindsight it turns out that participant uptake is slow.

The duty of prudence does not require fiduciaries to predict the future. Rather, fiduciaries must be judged based on the soundness of the investment process. A view that participants will value ESG-focused investments enough to participate more should not be taken on blind faith. It should be based on research, and should be grounded in street-level knowledge of that particular company's employees.

Not all fiduciaries will draw the same conclusion. Some will consider ESG and decide that participation and contribution levels will not likely increase, or will not increase enough to justify the communication burden and administrative cost. However, that decision is the prerogative of fiduciaries, not the regulator, based on evidence drawn from their research.

We believe a fiduciary could justify offering ESG funds in a voluntary 401(k) plan based on expectation of improved benefits through higher participant demand – and that the DOL should depart from past guidance by expressly permitting it. Guidance should focus on ensuring that ESG investment is an expression of informed choice by the participant:

- Non-ESG alternatives should always be offered
- ESG factors should not be incorporated into QDIA or default funds, where participants did not make an election
- ESG funds should be clearly labeled and accurately described, without hype or assurances of better performance
- ESG funds should be benchmarked to ESG-focused indices

In contrast, guidance should be different for traditional pensions and certain types of DC plans, where participation is mandatory and the employer provides the funding:

- ESG characteristics should not be mandated in the manager search process
- Only factors which lead to improved expected return adjusted for risk should be considered
- If an ESG-focused fund happens to win, it should be benchmarked to a general (non-ESG) index.

Why Issue Guidance?

It is a sad reflection on our times that ESG investing has become politicized. Extremists either advocate ESG investing with the fervor of religious zeal, or pan it as some sort of dark collectivist tool. Happily, fiduciaries tend to be much more reasonable! They may apply the principles of ERISA and arrive at different decisions on ESG investments, based on well-researched views on the subject and the nature of their particular retirement plans. It is fiduciaries, not the Department, that should decide whether an ESG-oriented investment fund furthers their Plans' benefit objectives.

Unfortunately, many fiduciaries are unwilling to seriously consider the issue. It is fear of litigation, not a sound position on the merits of ESG investing, that stops them. That is why regulatory guidance would be helpful – not to create new law (the current law is fine), but to clarify the application of fiduciary principles to the issue. It is unreasonable and unrealistic to expect corporate decision-makers to consider innovation in the face of so much predatory class-action litigation.

All that's required from your department is a clear and thoughtful dose of common sense, as outlined above, to empower fiduciaries to do their jobs and hold their predators at bay. To date, DOL guidance has only been consistent in lacking clarity. Now, you have a chance to correct this with a definitive statement. We look forward to reviewing the next and, hopefully, last regulation on this topic!

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