January 9, 2019

Mr. Brent Fields
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Re: File Number 4-725; SEC Staff Roundtable on the Proxy Process

Dear Mr. Fields,

I am the assistant director of the L. Charles Hilton Jr. Center at Florida State University and an affiliated scholar with the Mercatus Center at George Mason University. The Securities and Exchange Commission has asked for comments on the services provided by proxy advisory firms and whether such firms act in the best interest of funds and fund shareholders. This comment addresses whether environmental, social, and corporate governance (ESG) investing, an investment strategy often advocated for by proxy firms, is an appropriate strategy for public-sector pension plans.

Summary of key points:

- Public-sector pension plans are drastically underfunded.
- If future retirees are going to get the benefits they have been promised, it is imperative that pension plan administrators fulfill their duty to secure the required returns.
- Environmental, social, and corporate governance (ESG) investing criteria include goals other than maximizing investment returns. To the extent that these goals conflict with one another, ESG investment strategies will exacerbate public pension shortfalls and prevent retirees from getting their promised benefits.
- While an ESG strategy is fine for individual investors pursuing their own goals, it is problematic when instituted by public pension administrators since it may conflict with the goals of the fund's beneficiaries.
- Investment decisions and shareholder resolutions for pension funds should be driven by the fiduciary responsibility to generate optimal returns.

Introduction

Many state and local public-sector pension systems are drastically underfunded. A recent study from The Pew Charitable Trusts reports that in 2016 state pension funds had a cumulative deficit of $1.4 trillion and that the average state pension plan was only 66% funded[1].

But even these dire numbers do not tell the whole story since they are based on unrealistic investment returns. Decreasing projected investment returns increases the net present value of liabilities and thus the funding gap, which is the difference between a plan's liabilities and its

[1] Pew Charitable Trusts. The State Pension Funding Gap: 2016. April 12, 2018 https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/04/the-state-pension-funding-gap-2016

assets. According to Pew, lowering projected annual returns from 7.5% to 6.5% increases the 2016 funding gap from $1.4 trillion to $1.7 trillion.

Considering the current institutional environment and level of underfunding, it is important for public pension plan administrators to focus on earning the highest returns possible. Investment decisions that prioritize other goals, such as environmental or social goals, at the expense of higher returns will only widen the pension funding gap. The result will be either cuts in benefits to future and possibly current beneficiaries, taxpayer funded bailouts, or some combination of the two.

Public-sector pensions are drastically underfunded

In order to calculate employer and employee contributions, public pension plans assume a rate of return on investments. The rate of return is also used to calculate each plan's current liabilities. In the early 1990s the median assumed rate of return was 8% but since then it has fallen to 7.5%[2]. Unfortunately, this is still too high when compared to what pension plans are actually earning.

When the assumed rate of return is 7.5%, any investment return lower than 7.5%, holding everything else constant, increases the pension plan's funding gap. Over the last decade, state pension plans generated a 6% return and according to projections from Pew and others returns will only be 6.5% over the coming decade[3]. Any investment strategy that does not prioritize investment returns will exacerbate an already growing funding gap that will have to be closed by benefit cuts or larger contributions from employees or taxpayers.

Furthermore, state pension plans typically pay out more in benefit payments than they take in from employee and employer (taxpayer) contributions. Since the late 1990s this gap has widened, making state plans even more reliant on investment returns[4]. As stated in the Pew report:

> "As overall operating cash flow declines, mediocre investment performance is more likely to cause a drop in plan assets, which makes it harder for plans to generate returns in the future." (p. 12)

Another report from the Mercatus Center at George Mason University shows that states' public pension obligations are increasing relative to total state personal income, which means that obligations are growing faster than states' ability to pay[5]. This could make it difficult for states to close funding gaps through increased taxation. The report also notes that the pension situations in Connecticut, Illinois, Kentucky, and New Jersey are particularly dire.

ESG investing is inappropriate for public pensions

[2] The State Pension Funding Gap: 2016, Pew
[3] The State Pension Funding Gap: 2016, Pew
[4] The State Pension Funding Gap: 2016, Pew
[5] Norcross, Eileen and Olivia Gonzalez. Ranking the States by Fiscal Condition: 2018. Mercatus Center at George Mason University. Oct. 9, 2018 https://www.mercatus.org/statefiscalrankings

Environmental, social, and corporate governance (ESG) issues have become more common on companies' proxy ballots in recent years. ESG issues often focus on a company's environmental impact, such as pollution or carbon emissions; social issues such as employment diversity or wage inequality; or corporate governance issues such as the structure of the board of directors. ESG investing, or sustainable investing, is commonly defined as investing that considers various ESG criteria in addition to financial returns in investment decisions[6].

ESG investing is not a new concept. Individual investors have made investment decisions based on a variety of criteria throughout history. Public pension funds have also been active in ESG investing since the 1970s, though the specific ESG goal has changed frequently over time[7]. That said, the use of ESG criteria to screen investments has increased markedly since the early 2000s and today the majority of ESG-screened assets are held by public pension funds[8].

Considering environmental, social, or even political factors is fine for individuals investing their own resources. Such considerations become more problematic, however, when undertaken by public pension funds, which have a duty to ensure that their diverse clients receive their promised financial benefits. Unlike individual investments, the current and future retirees relying on public pension plans for their retirement likely have very different ideas about what makes up the public or social good. In addition, to think that pensioners prefer ESG investing to a fully-funded pension system that can deliver the retirement promised is unlikely.

ESG investing by public pension funds creates a standard principle-agent problem. The principles in this case are the fund's beneficiaries, which are retired public-sector employees and future retirees. The agents are the fund managers or legislators that make the investment decisions. The agents have a duty to act solely in the interest of the principles but this does not always occur. Agents may conceal their activities to pursue their own goals or inadvertently pursue the wrong goals due to a lack of information about what principles desire. For example, when the principles' non-financial interests diverge in ways that are unknown to the agent, which is likely the case with public pension funds, pursuing such interests becomes difficult if not impossible. Researchers Alicia Munnell and Anqi Chen note this difficulty[9]:

> "…one beneficiary may accept lower returns for fossil-free but not firearms-free investments, while a second one may accept lower returns for terror-free but not fossil-free investments, and a third may not accept lower returns at all." (p.5)

While individuals can easily navigate their own tradeoffs between various ESG goals and financial returns, pension plan administrators are more limited due to a lack of information and the principle-agent problem. In light of these limitations, it is prudent for plan administrators to

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[6] Fidelity. Investing based on your principles. 6/27/2018 https://www.fidelity.com/viewpoints/active-investor/strategies-for-sustainable-investing

[7] Munnell, Alicia and Anqi Chen. New Developments in Social Investing by Public Pensions. Center for Retirement Research at Boston College, no. 53. Nov. 2016.

[8] Ibid.

[9] Ibid.

focus on the primary goal of public pension plans, which is to produce a secure retirement income for the fund's current and future retirees.

The evidence for whether ESG investing generates lower returns is mixed, though several studies do find that ESG or sustainable investment strategies yield lower returns[10]. What is clear, however, is that a fund stating it will only pursue investments based on a model heavily influenced by ESG factors risks ignoring industries and companies that generate higher returns. Put simply, if ESG investing yields higher returns it should be pursued, and if it does not it should not. The ESG criteria themselves should not be the deciding factor for pension plan administrators acting on behalf of retirees who expect the administrators to secure their retirement income. Pension fund managers should pursue strategies that produce the greatest returns and anything else runs afoul of their fiduciary responsibilities.

In addition to the effect ESG investing can have on returns, it can also affect overall investment risk and volatility. Modern portfolio theory stresses the importance of having a diverse set of assets to mitigate industry and business-cycle risk. If ESG screening drastically shrinks the set of acceptable investments it can make it difficult for investors to achieve the appropriate mix of assets. While this may seem unlikely, the list of what is unacceptable by common ESG standards is continuously changing and often growing. What started out as a way to avoid investing in alcohol, tobacco, defense, and gambling companies has expanded and now includes many fossil fuel and car companies, as well as Facebook, Amazon, and Apple[11].

To ensure pension plans can provide beneficiaries the secure retirement promised plan administrators must be free to invest in companies that yield the greatest returns. Tying their hands and refusing to allow certain investments based on the political and social preferences of a few makes it more likely that funding gaps will continue to grow and further fuel a pension crisis. Principled investing that will produce the necessary earnings should be the path pursued.

Finally, pension funds' pursuit of shareholder resolutions based on ESG – which can harm financial returns – often interferes with the fund's fiduciary responsibility to pensioners. To repeat, pension funds' paramount concern should be greater returns and ensuring their plans are adequately funded. Their agendas should not focus on pushing corporate policies that damage the economic standing of companies and thus produce lower returns for the pension fund. Such actions are counterintuitive yet are currently prevalent in corporate governance debates today.

Conclusion and future reforms

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[10] For some examples see:
Auer, Benjamin R., and Frank Schuhmacher. "Do socially (ir) responsible investments pay? New evidence from international ESG data." *The Quarterly Review of Economics and Finance* 59 (2016): 51-62.
Belghitar, Yacine, Ephraim Clark, and Nitin Deshmukh. "Does it pay to be ethical? Evidence from the FTSE4Good." *Journal of Banking & Finance* 47 (2014): 54-62.
Capelle-Blancard, Gunther, and Stéphanie Monjon. "The performance of socially responsible funds: does the screening process matter?." *European Financial Management* 20, no. 3 (2014): 494-520.
[11] Rach, Sonia. ESG managers shun outperforming Faangs. July 26, 2018. https://esgclarity.com/esg-managers-shun-outperforming-faangs/

The primary goal of a public pension plan is to make good on the plan's financial promises to current and future retirees. Considering the current underfunding of public pensions, there is no room for pension plan administrators to sacrifice returns for the sake of other non-financial goals such as ESG. Moreover, if pension plans do not shore up their funding some combination of taxpayers and future retirees will be required to make up the difference. This is unfair to the members of those groups who rightfully expect pension administrators to focus on fulfilling the financial promises of the plans they oversee.

The drawbacks of pension plans pursuing an ESG investment strategy and shareholder resolutions driven by ESG principles would be eliminated if plans ceased investing in companies altogether and instead invested in less risky Treasury bonds, as recommended by many economists and financial experts[12]. Unfortunately, this is unlikely to occur anytime soon given the effect it would have on pension finances.

Thus, in the meantime pension plans should pursue investment strategies that produce the returns they need to make good on their promises to current and future retires. Investment strategies that sacrifice returns for nebulous environmental, social, or political goals put public sector workers and taxpayers at even more risk than historical pension plan mismanagement has already exposed them to.

Thank you for the opportunity to comment on this issue.

Sincerely,

Adam A. Millsap, PhD
Assistant Director, L. Charles Hilton Jr. Center at Florida State University
Affiliated Scholar, Mercatus Center at George Mason University

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[12] Novy-Marx, Robert, and Joshua D. Rauh. "The liabilities and risks of state-sponsored pension plans." *Journal of Economic Perspectives* 23, no. 4 (2009): 191-210.